Prudence, Patience and Jobs

Pension Investment in a Changing Canadian Economy — Technical Report

Prudence, Patience and Jobs: Pension Investment in a Changing Canadian Economy
Technical Report

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The Canadian Labour Market and Productivity Centre (CLMPC) is an independent national labour-business organization whose mission is to contribute to economic growth and the betterment of society by improving business-labour relations in Canada and by providing joint advice on public policy, particularly related to labour market and productivity issues.

The author of this report is Kirk Falconer, Canadian Labour Market and Productivity Centre.

GST Registration No R100767268.

Canadian Labour Market and Productivity Centre
55 Metcalfe Street, Suite 1500
Ottawa, Ontario K1P 6L5
Canada

Telephone: (613) 234-0505
Facsimile: (613) 234-2482
E-Mail: clmpc@magi.com
Web-site: www.clmpc.ca

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Preface

To most of us, the topic of pension funds suggests concerns of aging, retirement and long-term economic security. In other words, we think about such personal questions as: *Exactly how much money will I need to ensure comfort and a good quality of life in my senior years?* Canadian public policy and the media reflect these pre-eminent household concerns, evident in recent discussion about the challenges presented to society in an aging population and increasing calls on government treasuries to guarantee the provision of adequate health care and income security programs. In this context, the role assumed by employer-sponsored (or occupational) pension funds is a vital one for many Canadian workers, retirees and their families.

Increasingly, public policy also views pension funds from an entirely different perspective: their fast-growing importance as institutional investors in the Canadian financial system. Employer-sponsored funds are not just a principal source of retirement income to many working people, they are also large and influential financial institutions that perform a current economic function in converting national savings into productive, value-added investment that can create jobs.

To what extent do these different roles positively converge? The singular priority of pension trustees and managers is to obtain optimal revenues from investing in a prudent fashion. Legislators and governments must be concerned about maintaining a social policy framework that accounts for trends in the Canadian retirement income system and anticipates an aging population. At the same time, there must be confidence that pension asset allocations act to facilitate national economic policy requirements. The challenge here is to find an effective and efficient way of maximizing the intersection of these distinct and occasionally conflicting imperatives.

Consideration of pension funds in this new light is long overdue. This report by the Canadian Labour Market and Productivity Centre (CLMPC) undertakes the task of examining pension funds in their second and less-well-known function as economic agents. In particular, *Prudence, Patience and Jobs: Pension Investment in a Changing Canadian Economy* looks at the role and performance of pension investment activity in fostering positive output, productivity and employment outcomes in an era of major change and restructuring. In so doing, it aims to increase appreciation of funds in this realm and help broaden and deepen public discussion.

The following is a **Technical Report**. A **Summary Report** for this document, forty pages in length and of the same title, is also available through the CLMPC.

Acknowledgements

Prudence, Patience and Jobs would not have been possible without the generous help of a great number of individuals and organizations in Canada, the United States, the United Kingdom, Australia and elsewhere internationally.

Firstly, the CLMPC acknowledges, with thanks, the financial contribution of the Labour-Management Partnerships Program of Human Resources Development Canada.

Secondly, it is important to note that the research contained in *Prudence, Patience and Jobs* has relied heavily on interviews conducted over 1997-98. Informants included representatives of academe, research and market analysis agencies, business and labour constituencies, federal and provincial governments, not to mention the community of pension trustees, money managers, advisers and regulators. For a comprehensive list of these, see **Key Project Informants**. The CLMPC warmly acknowledges this sharing of expertise.

Special thanks to those who contributed extensively to CLMPC research by supplying data and analysis, advice on key issues, and/or feedback on report drafts. This includes project consultants Mary Macdonald (Macdonald & Associates), Bob Baldwin and Dick Martin (Canadian Labour Congress) and Gordon Sharwood (Sharwood and Company). Regular contributors also included such senior pension fiduciaries as Darcie Beggs, Drew Bucknall, Bill Clark, Lynn Clark, Ian Collier, Jean-Claude Cyr, Heather Gavin, Russell Hiscock, Michael Lay, Andreé Mayrand, Michel Nadeau, Doug Pearce and Don Walcot, as well as Keith Douglas of the Pension Investment Association of Canada (PIAC). Also included are capital market researchers Randy Barber, Tessa Hebb, Ted Jackson, Regina Markey, and Allan Riding, pension analysts Keith Ambachtsheer and Isla Carmichael and market practitioners Michael Brown, Peter Friend, Kevin McKenna, Robert Olsen, David Podmore, Hugh Rorison, Tony Stephens, Bob Tattersall, Sebastian Van Berkom and Sam Znaimer.

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Thanks to Jean-Guy Bourgeois for his assistance in the research, and to the staff of the Pension Section of Statistics Canada, the magazine *Benefits Canada*, and the federal Department of Finance for their regular consultative contributions.

Finally, thanks to officials and staff of Canadian and non-resident corporations, financial institutions and pension funds that gave the CLMPC very generous access to their operations and records for the purpose of case study and who, in many instances, also provided considerable input and support.

Introduction

Canadian employer-sponsored or occupational pension funds are a cornerstone in the nation's system of providing guaranteed income to working people and their families in retirement. With a total asset base of over $500 billion (i.e., the dominant fraction that is trusteed) in 1998, these funds form the most sizeable portion of a system that also consists of federal and provincial income security programs, the Canada and Quebec Pension Plans and registered retirement savings plans.

Employer-sponsored pension funds are based on the deferred wages and benefits of employees. These comprise plan assets that are held in trust for the sole interest of plan members who are both participants and beneficiaries. Trustees are responsible for plan administration, policy-making and oversight of asset allocations and management which, if performed prudently and efficiently over time, will augment the value of worker savings for retirement. This is a fundamental and legally sanctioned mandate. It cannot be ignored, bypassed or subordinated to any other goal. Nor can it be changed lightly by legislators, trustees and other fiduciaries or any other stakeholders in business, labour or government.

To ensure the "pension promise", fiduciaries are expected to govern their fund organizations with care and diligence and to avail themselves of the skills and experience of professionals in making informed decisions. Moreover, every investment decision and action must be transparent and measured against the prudent person rule embodied in Canadian law. Consistent with this and other fiduciary imperatives, such as balancing assets with liabilities over an appropriate time line, the lion's share of pension money tends to flow to such relatively safe and liquid asset classes as public stocks, fixed income and cash.

Pension funds are also financial institutions. As predicted by American academic Peter Drucker (*The Unseen Revolution*, 1976) and other observers decades ago, such funds have accumulated assets at such a rapid pace that they have, in a short time, emerged as an overwhelming presence in the capital markets of advanced industrialized economies around the world. In Canada, pension funds have expanded by seventy-five times their recorded size in the mid-1960s. As a consequence, today, they make up this country's second largest pool of capital resources, after the banks. In national public securities exchanges, pension funds perhaps wield their greatest clout as the owners of close to 40 percent of corporate equity.

In other words, while employer-sponsored pension funds are essentially an instrument of Canadian social policy — giving them legal and fiduciary roles and obligations that set them apart from the rest of the financial system — they are also potent institutional investors. Furthermore, they have increasingly deep roots in a diverse number of private and public capital markets. They are inevitably a vital force in the national economy.

These increasingly large and influential funds also cannot help but register an impact, one way or the other, on Canada's ability to convert savings into productive investment and capital formation that, in turn, produces economic output, jobs and incomes. Indeed, as they grow, individually and collectively, their real and potential impact on economic outcomes grows commensurably. This is most apparent in the very largest private and public sector pension funds that are compelled always to seek new sources of investment diversification by which they can maximize financial returns, according to conventional risk-reward analysis.

On this journey, pension investment may generate what economists refer to as "collateral benefits", or effects in the Canadian economy or society that are ancillary to the primary aim of obtaining optimal earnings performance. In the majority of instances, collateral benefits emerge incidentally, meaning that while pension funds have allocated assets solely in the pursuit of financial returns, they have inadvertently created non-financial ones. These can include growth, jobs or local development, among other social goods, and can be elicited due to pension participation in multiple capital markets and market segments. Of course, being incidental doesn't make benefits any less valuable.

Collateral benefits can also be obtained more strategically. This activity is often described as asset-targeting (e.g., economically-targeted investments, or ETIs, in the United States) that entails a calculated intention on the part of pension funds to generate specific ancillary effects from investment while continuing to treat earnings as the first and over-riding priority. To guarantee this, successful asset-targeting is undertaken within a strict fiduciary framework.

The collateral benefits of pension investment — be they incidental or intended — may be more important to Canadians today than ever before. This is because of the national economy's continuing progress along a path of comprehensive change and restructuring. As high levels of unemployment persevere at present, there is an increasing need to identify and support those industries and sectors that promise the next generation of growth and jobs. In recent years, it has become apparent that capital markets and financial institutions are not neutral in this regard. On the contrary, as American economist Michael Porter has argued, a nation's stock of capital resources may well be wasted or under-invested unless they are strategically deployed to reach an economy's highest productivity potential.

In Canada, public policymakers at all levels, and many representatives of labour and management, have come to recognize and appreciate this point. They are paying more attention to access to capital issues relevant to new business births, growing small and medium-sized enterprises (SMEs) and other traditional and non-traditional industrial development that is job-creating or job-protecting. A key challenge here is to deal with access to capital impediments, by filling gaps in financing or assisting the evolution of those capital markets particularly suited to this task.

Prudence, Patience and Jobs: Pension Investment in a Changing Canadian Economy investigates the role of pension funds in this process. One of challenges for the Canadian Labour Market and Productivity Centre (CLMPC) in doing this is the absence of a comprehensive and detailed national database and related research literature that casts light on these funds as financial institutions, both current and historical. Apart from the excellent information provided annually by Statistics Canada and the magazine *Benefits Canada*, and a few other sources, there is very little published work that can contribute meaningfully to an examination of the function and direction of pension investing of consequence to Canadian economic change.

For this reason, the CLMPC determined to collect and analyze data from selected private and public capital markets, where available, and supplement these with anecdotal and illustrative information. For the most part, the latter pertains to how, practically speaking, individual pension funds or their money managers engage in these markets over the long-term. These brief case profiles are matched with similar profiles of pension participation outside of Canada, and especially, in the United States.

The CLMPC also conducted or collaborated in two surveys for this research project. The first was a survey performed by the CLMPC in co-operation with the Pension Investment Association of Canada (PIAC) on fourteen barriers. These barriers were identified in prior CLMPC interviews with pension managers, market analysts and practitioners, and in selected research studies, to investment activity that may yield intentional or unintentional collateral benefits. The findings of the CLMPC-PIAC survey are crucial to this subject and provide a basis on which further data gathering, analysis and related initiatives may occur. Indeed, the survey was a formative influence in the latter stages of CLMPC research. Findings proved it was essential to give more extensive consideration to the formidable nature of certain barriers and their ability to determine investment patterns, irrespective of their origins in financial and non-financial return goals.

The second survey was performed by the Ontario Public Service Employees Union (OPSEU), in co-operation with the CLMPC, on labour participation in pension governance and investment decision-making. This work by OPSEU is also significant in helping to define a positive role for Canadian pension plan members and their unions in this on-going discussion and in potentially establishing new opportunities for labour-management consensus-building.

Data, analysis and discussion in this CLMPC report is organized in the following manner:

- ✓ Section II provides a general summary of the outlooks of Canadian business and labour constituencies that are the institutional members of the CLMPC. This overview focuses on constituency views of pension investment from an economic change perspective.
- ✓ Section III considers the practice of investing and managing Canadian pension assets. Attention is paid to the growth of pension funds, pension governance processes and structures, historical and current investment patterns and the relationship of these to the economy.
- ✓ Section IV provides a general introduction to four capital markets relevant to financing investment in Canadian economic change and restructuring and to which pension funds have some connection.
- ✓ Section V examines the role of pension funds in the Canadian venture capital market.
- ✓ Section VI examines the role of pension funds in the Canadian middle market.
- ✓ Section VII examines the role of pension funds in Canadian public securities exchanges with specific reference to investment in small-cap stocks.
- ✓ Section VIII examines the role of pension funds in Canadian real estate markets and infrastructure investment.
- ✓ Section IX provides the background to the CLMPC-PIAC survey and its findings. This section discusses the character and extent of pension barriers to investment in private capital markets as well as some alternative policies and strategies for overcoming them, drawn from Canadian and international sources.
- ✓ Section X provides a summary of the CLMPC's *Patience, Prudence and Jobs*, along with some suggestions for future work on this topic.

Also enclosed are illustrative figures, a glossary of financial and other terms used in this document, a list of most commonly-cited acronyms and a selected bibliography. An Appendix includes a list of key Canadian pension trustees and money managers, capital market analysts and practitioners, business, labour, government and non-governmental organizations who were interviewed or consulted by the CLMPC for this project. These persons made very substantial contributions to data and insights over the past year and some months.

1. Constituency Views of Pension Investment in a New Economy

Views of the business constituency

Special characteristics of pension funds impede their emergence as sufficient sources of financial capital for Canadian business. Part of (their) emphasis on liquidity stems from the emphasis of pension fund managers and, indeed of North American managers in general, on short-term instead of long-term gains. When quarterly results are the focus of attention; there is a tendency to be overly concerned with liquidity and the short-term.
— Canadian Chamber of Commerce, 1988

All is not as well as it could be with Canada's medium-sized companies...Too few of them move up to become larger companies. Too few small companies become medium-sized companies.
— Gordon Sharwood, Sharwood and Co., 1989

Difficulty in accessing capital limits the ability of firms to up-grade technologies or establish new ventures. As a result, it serves to weaken dynamism in the economy as a whole.
— Michael Porter, Canada at the Crossroads, 1991

The concern of many in Canada's business constituency about the investment and management of pension assets can probably be summed-up in one phrase: access to capital. In the not-so-distant past, the relationship between our national savings, investment and capital formation, and our prospects for continuing economic growth, employment and wealth creation, was seen as a fluid and uncomplicated one. More recently, this relationship has come under the microscope.

This is due entirely to the nature and pace of economic globalization, the liberalization of trade and finance, and increasing diffusion of automation and new technologies. These confluent developments are redefining competitiveness for business in the Canadian economy and, over time, assist in determining what industries are likely to exhibit growth while others exhibit decline. The basis of a so-called "new" economy — innovation geared to more use of knowledge, technology and skills — is evident in the market advantage gained by those traditional and non-traditional Canadian industries that best reflect the value these elements add to production.

Continuing economic change and restructuring of this variety requires a major commitment of capital resources. American economist Michael Porter saw this when he said that advanced industrialized countries such as Canada could no longer afford to view the relationship between industry and finance as straightforward. Rather, Porter argues, in a new and more competitive global economy, a nation's stock of capital, no matter how vast, would only be effective if it was deployed strategically to reach our best economic growth prospects. This is a long-term endeavour and one that requires a greater degree of financial innovation, specialization and adaptation to the demand needs of knowledge-based and technology-intensive firms. In short, says Porter, a new economy requires smarter capital and more patient capital.[1]

Is this happening to the extent it should in Canada in the 1990s? Some businesspeople would answer in the negative, pointing to the real and perceived barriers to capital availability faced by small and medium-sized enterprises (SMEs) that remain responsible for a disproportionate share of gross and net new jobs in the national economy. Perversely, SMEs and their economic contribution of new company formations, multi-stage business development and expansion and the emergence of high technology industries, are constrained by problems in accessing enough affordable debt and equity financing.

The Canadian Chamber of Commerce, in co-operation with the CLMPC, helped to confirm the facts of this situation. In a 1995 survey of 1,500 SME members of the Chamber, the CLMPC found that over one-half of respondents believed their access to capital circumstances were only somewhat adequate or were not adequate. Perceived impediments were more pronounced for the smallest and youngest of these firms. Furthermore, high technology enterprises were likely to confront twice as many financing roadblocks as their low technology counterparts.[2]

What does this have to do with employer-sponsored pension funds? Well, a lot, say some market analysts and practitioners. Research attesting to intractable barriers to financing in the current Canadian economic context has raised business concern about a possible "disconnect" between productive investment demand, on the one hand, and optimal allocation of capital resources, on the other.

Historically, most aggregate pension asset allocations in Canada have eluded entrepreneurs and SMEs for the simple reason that the latter represent a much higher level of cost, illiquidity and risk than other types of investment. This situation is something of a quandary: here we have one of Canada's largest capital pools disinclined to supply new and developing business that is not only potentially prosperous, but that also offers the potential collateral benefits of future jobs, income and living standards to Canadians.

Many in Canada's business constituency believe this must change. Indeed, some might likely echo the voice of American business management professor Peter Drucker, who was one of the very first to argue that the legal and fiduciary policy restrictions governing pension investment had to be reformed to help them address key economic challenges in the United States and elsewhere. Today, Drucker continues to maintain that pension investment decisions function on too narrow a definition of risk and is inordinately pre-occupied with liquidity and short-term returns. Instead, he says, pension funds should concentrate more on the long-term, wealth-producing capacity of a national economy.[3]

The "Drucker thesis" has several strong proponents in Canada, especially in the business constituency. An important example is seen in the above-quoted *Focus 2000 Task Force Report on Making Investment Capital Available*, issued by the Chamber in the late 1980s.

In *Focus 2000*, Chamber representatives were concerned about the limited engagement of Canadian pension funds in SME financing of all kinds and, in particular, as a source of supply to the then fledgling venture capital market. To rectify this situation, new incentives were recommended to support the equity participation of funds as well as a target of five percent of total pension assets to venture financing.

Interestingly, the *Focus 2000* report was published at a time when pension funds were close to doubling their commitments to the institutional venture capital market, predominantly through indirect, externally-managed pooling vehicles (e.g., limited partnerships). At the beginning of the 1990s, many funds and other institutional investors moved to reduce their commitments or to withdraw from this and other private capital markets altogether. In other words, Canadian pension funds are further away from the Chamber of Commerce's objective today than they were a decade ago.

Views of the labour constituency

For the most part, unions whose members belong to workplace pension plans have little to say about how the penion funds are invested. (F)unds are used to buy stocks and bonds and few questions are asked about the securities that are bought except what rate of return should be expected... This state of affairs has been questioned by trade unionists from a number of perspectives.

— Canadian Labour Congress, 1998

Our bottom line is that pension fund money is plan member money — deferred wages — and it is the plan members that must decide how best to use their money. We believe that our pension funds can and should be used to help our communities and the economy.

— Darcie Beggs, Canadian Union of Public Employees, 1993

Given the great need for investment capital, there can be no restructuring of the (Canadian) economy that does not include a role for pension funds.

— United Steelworkers of America, 1991

The interest of a growing number in the Canadian labour movement in the investment and management of pension assets can probably be summed-up in a single word: jobs. At a time of high unemployment — and following a prolonged period of loss of jobs in traditional construction, manufacturing and resource industries, many of them permanently lost — labour is anxious about the capacity of the national economy to create new jobs or protect existing ones.

Canadian workers and their unions believe that there must be not only an increase in the quantity of jobs, but also an increase in quality. To maintain the living standards of working people and their families, new jobs must be predominantly full-time, value-added and well-paying. Moreover, existing, quality employment must be preserved.

This outlook is well-expressed in *Vanishing Jobs* (1995) in which economists Lars Osberg, Fred Wien and Jan Grude discuss the ramifications of shifts in the balance of job quantity and quality for the Canadian social fabric. This book asks: How can "good" jobs be sustained and what future sources will ultimately replace lost jobs with new ones of comparable value?[4] Of course, part of the answer lies in the advent of high-skill knowledge-based and technology-intensive production, and expansion in the labour force representation of knowledge and information workers. However, such developments are not as yet having a pervasive impact on the levels of jobless Canadians. Nor are they reaching into economically-disadvantaged communities and regions of the country where job losses have been most damaging.

Over the years, concern about the social consequences of cyclical and structural changes in the Canadian economy has led labour to examine more closely the connection between the financial system and productive investment decisions that are clearly job-creating or job-protecting. For instance, labour is more attuned to the heightened global mobility of capital resources and of its many possible implications. Some have argued that greater financial exposure to markets overseas may result in fewer such resources at home to support Canadian economic and social priorities.

Others have been active in defining a role for labour in mobilizing new capital sources. This is evident in the growing incidence in Canada of worker buyouts and other forms of worker ownership, often to keep traditional plant operations from shutting-down or to assist firms engaged in extensive restructuring to weather cost and competitive pressures in the short-term. Another manifestation is seen in the rise of labour-sponsored investment funds, beginning with the Fonds de solidarité des travailleurs du Québec (FTQ) in 1983 (documented by the CLMPC in 1995). In this case, fund sponsors in national unions and provincial labour federations have perceived the job maximization potential of new and developing SMEs.[5]

In these and other illustrations, Canadian unions and union centrals have embraced collective strategies for investment and capital formation that perform job-related mandates. Up until very recently, such strategic activity did not rely on the backing of employer-sponsored pension funds. In fact, some in labour have strongly opposed use of pension assets for this purpose, citing possible violations of fiduciary responsibility and other reasons.

With the passage of years, however, many in the Canadian labour movement have increasingly turned their attention to the investment and management of pension assets. Like their counterparts in business, many labour representatives take the view that short time horizons for pension investing will invariably create short-term growth and short-term jobs. Where individual Canadian unions have issued policy statements on such matters, they have urged that pension funds adopt a longer-term perspective of investing that accounts for the best interests of workers and their employment.

Some of the inspiration behind this new disposition comes from the spread of knowledge about practical asset-targeting models that have been shown to generate both market-grade returns, according to conventional averages and indices, and desired collateral benefits. In the United States, the phenomenon of "economically-targeted investments" (ETIs) has given birth to several programs for strategically pooling or otherwise directing a small, fixed portion of pension assets to meet certain economic or social investment goals. American labour is actively supportive of these, including those targeting affordable housing development, using unionized workers, or job-creating SMEs, in a community economic development context.

Though there are no ETIs in Canada, strictly speaking, comparable asset-targeting has emerged that treats pursuit of collateral benefits as a prudent and legitimate secondary aim of investing, after optimal earnings. Some of these also enjoy the support of local unions.

Associated with this new focus is some Canadian union promotion of methods for introducing social responsibility criteria, screens and accounting procedures to pension asset allocations similar to those performed by ethical and environmental mutual funds and several labour-sponsored funds. Newer still is an effort to link social criteria with pension asset management, in the form of shareholder activism. Indeed, national labour movements around the world are seizing on the potential such activism offers in influencing corporate citizenship and governance.

It was in response to growing interest among unions and union members on this topic that the Canadian Labour Congress recently introduced policies endorsing greater exploration of pension investment issues at the national level. A vital prerequisite for many in the labour constituency is establishment of a more central and authoritative role for employees and other plan members in pension governance and investment decision-making.[6]

Prudence, Patience and Jobs discusses the connection between the investment management of Canadian pension assets and job-creating SMEs and larger firms, both traditional and non-traditional, through private and public capital markets. It also considers what opportunity now exists for enhanced pension participation in solving capital availability problems in a manner that helps meet the new economic and social priorities of the country, as desired by many in both the Canadian business and labour constituencies.

An opportunity for consensus?

In a very real sense, the governance of employer-sponsored pension funds has for a long time reflected an amount of labour-management co-operation, consensus-building and joint decision-making, in both the private and public sectors. This is most evident in joint trusteeship, the incidence of which has grown markedly since the 1980s (see **Investing and Managing Pension Assets in Canada**), as well as other administrative arrangements wherein employers formally share decision-making with employees or otherwise seek the input of plan members.

In addition, it has been pension governance structures featuring employer-employee co-operation that have given rise to new and innovative strategies for asset-targeting or otherwise expanding capital market participation. Jointly-trusteed public sector funds and private sector multi-employer funds, for example, have frequently shown leadership in developing strategies that effectively reconcile prudence, fiduciary responsibility and investment activity that facilitates a strong and healthy economy.

There exists a certain degree of common ground between business and labour. This was also apparent in consultative exercises undertaken by the CLMPC in the past few years, beginning with the 1992-93 economic restructuring initiative involving senior labour and management leaders from across the country. More recently, a bipartite task force of the CLMPC convened in 1994-95 with a mandate to study, discuss and make recommendations concerning SME access to capital, a process that concluded with the report *Generating Growth*.

In light of this experience, Canada's business and labour constituencies are well-positioned to articulate their mutual concerns on this topic. This they might do in further co-operation with government in all Canadian jurisdictions, given that the concerns felt and expressed by legislators and public policy-makers are, in tone and content, very similar to those of business and labour.

2. Investing and Managing Pension Assets in Canada

Introduction

Since their earliest manifestations in the late nineteenth and early twentieth centuries, Canadian employer-sponsored pension funds have demonstrated growth and evolution that is nothing short of remarkable. Especially in the postwar years, they have grown to become the most sizeable pillar in the national system that provides retirement income security to working people. At the same time, pension funds have emerged as a massive financial sector, now inordinately influential in the economies of most advanced industrialized countries, especially as an owner of — and lender to — large, publicly-listed corporations.

The modern pension experience has been well-profiled by Statistics Canada. Since 1957, it has performed regular surveys of this sector. A second source of aggregate data is the annual survey of the largest 100 pension funds (i.e., above $1 billion in total assets) published by the magazine *Benefits Canada* for several years.

Employer-sponsored pension funds can be described from many angles. With respect to promised benefits, such may be defined benefit plans, defined contribution plans or hybrids of the two. They may exist for private sector or public sector workforces. Some are contributory (i.e., employees contribute to the cost of benefits along with employers), others are non-contributory. Some are founded on a single employer system while others are organized in a system that unites multiple employers.

Of course, a defining characteristic is the status of plans under Canadian law, as most employers will register these with government regulatory and tax authorities, and most duly-registered plans are funded according to formal trust agreements. In 1996, Statistics Canada reported that trusteed pension funds held 90 percent of the assets invested by registered plans and close to two-thirds of all registered monies in plans, whether invested or not. They also reflected the active membership of 3.8 million Canadian workers.[7]

The essential basis of public data collection and analysis by both Statistics Canada and *Benefits Canada* is this universe of registered, trusteed pension funds. Furthermore, both sources tell a similar tale concerning the progress of these funds, including developments in their collective institutional features as well as their rapid accumulation of capital resources under management in recent years.

The following is a brief discussion of the growth of Canadian employer-sponsored pension funds, followed by an introduction to technical matters pertaining to their governance and modes of decision-making. Together these form a necessary prelude to a concluding overview of essential factors that determine pension investment policies, processes and patterns in a contemporary economic context.

Growth and still more growth

Statistics Canada has recorded the development of trusteed pension funds at market value (i.e., net cash flow plus capital market appreciation) since 1965 when total assets stood at $6.7 billion. Since then, rates of growth have been brisk, healthy and sustained. Following peaks in the 1970s and 1980s, funds have tended to grow at average annual rates of just over 10 percent. This has meant that by 1998, the asset base of this largest category of employer-sponsored pension funds expanded by seventy-five times its recorded size in the mid-1960s and may well be 100 times larger early in the next century.[8]

Asset growth is determined by the interplay of several variables. These include employer-employee contribution levels, investment revenues and the introduction of new plans. Accelerating rates since the late 1980s can be explained primarily by increased pension asset allocations to public equity (chiefly at the expense of fixed income), which have demonstrated record appreciation and high profits on the sale of securities. Of equal importance is what might be described as a "restructuring" within the wider galaxy of employer-sponsored pension funds.

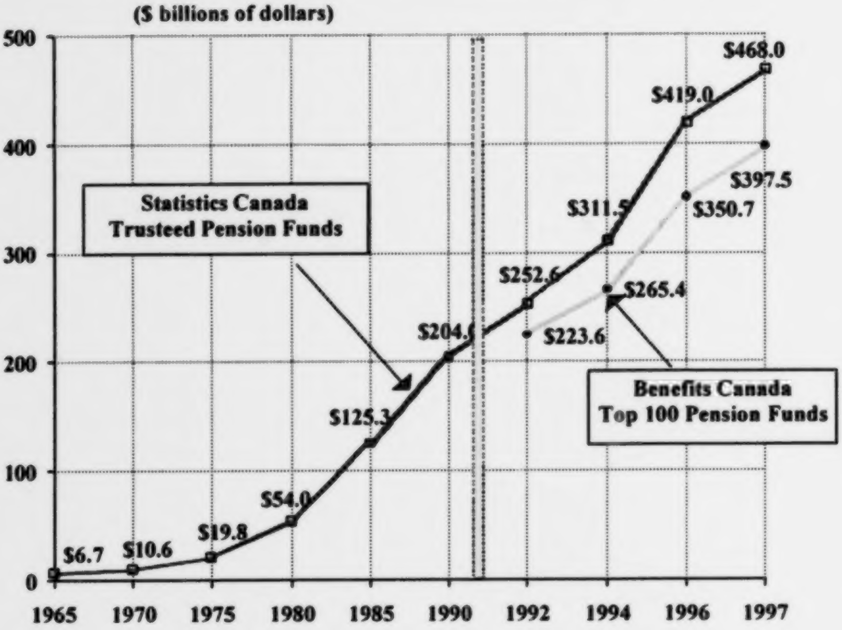
There has been, for example, gradual movement of large public sector pension plans away from a pattern of investing in non-marketable securities to first-time capital market participation. This is well illustrated by the recent history of the Ontario Teachers Pension Plan Board (PPB) — which in 1990 had a $16 billion portfolio of non-marketable provincial bonds. In a few short years, it emerged with a portfolio that is broadly diversified by asset class, completely revamped according to its debt-equity ratio, and reaches into many capital markets, private and public, at-home and abroad. British Columbia public sector funds went through a similar transformation beginning in 1991. A parallel trend is the breaking-up of several massive public sector pools, sometimes precipitated by government privatization as happened in the case of the federal Transport Canada employees, or the spin-off fund from

$100-plus billion superannuation account of the federal public service, scheduled to take effect in 2000.

The cumulative result of these and other events has been a better than doubling of assets held by trusteed pension funds — from $204 billion at the beginning of the decade to $468 billion at the end of 1997 (see Figure 1). By mid-1998, total assets shot past the $500 billion level.

Looking at Statistics Canada and *Benefits Canada* data, an immediately recognizable trend is the ascendance of the public sector fund category in a few years. Set up by federal, provincial and municipal governments — including crown corporations, agencies and certain educational and health institutions — these funds held 61 percent of total assets, according to Statistics Canada, while covering slightly less than half of all plan members.[9]

Figure 1
Growth of Employer-sponsored Pension Funds in Canada, by Total Assets (at Market Value), 1965-92 and 1992-97



Sources : Statistics Canada, *Trusteed Pension Funds, 1965-1996; Quarterly Estimates of Trusteed Pension Funds* (4th Quarter, 1997), 1998; *Benefits Canada*, "The Top 100 Pension Funds", April editions, 1993-1998.

As Figure 2 shows, with assets of almost $53 billion at the end of last year, Ontario Teachers PPB is now Canada's largest individual pension fund, as it has been since 1993, followed closely at $49 billion by the Government and Public Employees Retirement Plan of Quebec. At nearly $30 billion in total assets, the third largest is the Ontario Municipal Employees Retirement System (OMERS). These three head *Benefits Canada*'s list of the top 100 pension funds by exceptionally wide margins, given that the fourth largest — the Hospitals of Ontario Pension Plan (HOOPP) — stands at just over $13 billion.

A still greater proportion of the largest pension funds is situated in the public sector (63 of 100 in 1997). Indeed, *Benefits Canada* reveals an especially heavy concentration of capital resources in the top handful. For instance, of the top twenty, only five are private sector funds.[10] A parallel trend is underway in the United States, led by that country's largest public sector plan, the $130 billion-plus California Public Employees Retirement System (CalPERS).

At just above or below $10 billion in total assets, respectively, the two largest private sector pension funds in Canada are the group of Bell Canada or BCE pension plans, managed by the in-house Bell Investment Management Corporation (BIMCOR), and Canadian National Railways Pension. The third largest is the over $6 billion construction industry pension plan administered by the Commission de la construction du Québec (CCQ), while the fourth, at over $5 billion, is the pension plan of General Motors of Canada.

Be they private sector or public, consideration of pension asset concentration at the top is not an academic exercise. Rather, viewing those with exceedingly high asset levels — $4 billion (the top twenty), $9 billion (the top ten) or $25 billion (the top three) at the end of 1997 — sheds some light on the degree to which a small collection of mega-funds wield particular clout in Canada's financial system. This clout is all the greater in public securities exchanges. In a universe of well over 3,500 funds in total, the twenty largest, taken together, reflect over 57 percent of all assets. The top ten reflect very nearly 44 percent, and the top three, 28 percent.

What Statistics Canada and *Benefits Canada* data do not highlight is the further consolidation of the assets of public sector pension plans through several money management institutions. This trail was blazed by the Caisse de dépôt et placement, established by legislation in Quebec in 1965, with current total assets in excess of $64 billion. Much of the latter dollar amount is derived from fourteen employer-sponsored plans, including the Quebec public employees plan and CCQ, as well as the Fonds du Régime de rentes du Québec.[11]

In British Columbia, a comparable model emerged in the late 1970s and has since been re-organized in the provincial Ministry of Finance and Corporate Relations as the legally-independent Office of the Chief Investment Officer (OCIO). With current assets of $52 billion, the OCIO is the money manager for seven public sector pension plans, including the British Columbia Municipal Superannuation Fund and the British Columbia Public Service Basic Superannuation Fund.[12] Similarly, five pension plans, such as the

Figure 2
The Top Twenty-five Pension Funds in Canada, 1997

Rank	Pension Fund	Market Value (as of Dec 31) $ millions	In-house (%)	Balanced (%)	Specialist (%)
1	Ontario Teachers	$52,948.0	88.5	0	11.5
2	Quebec Public Employees	$49,000.0	45.4	54.6	0
3	OMERS	$29,520.0	81.0	0	19.0
4	Hospitals of Ontario Pension Plan	$13,093.0	86.1	0	13.9
5	B.C. Municipal	$10,985.6	74.4	0	25.6
6	BCE Inc.	$10,462.6	0	100.0	0
7	Ontario Hydro	$10,097.0	75.0	0	25.0
8	Ontario Pension Board	$10,029.0	39.8	48.2	12.0
9	Canadian National Railways	$9,874.2	99.0	0	1.0
10	B.C. Public Service	$9,226.1	74.7	0	25.3
11	B.C. Teachers	$8,232.5	68.4	0	31.6
12	Hydro-Quebec	$7,800.0	50.0	0	50.0
13	OPSEU Pension Trust	$7,707.0	33.2	0	66.8
14	Alberta Local Authorities	$7,204.8	84.8	0	15.2
15	Quebec Teachers	$6,700.0	100.0	0	0
16	Quebec Construction	$6,177.0	0	100.0	0
17	General Motors of Canada	$5,484.0	0	0	0
18	Nova Scotia Public Service	$5,330.0	34.7	0	65.3
19	Canadian Pacific	$4,908.9	92.0	0	8.0
20	Air Canada	$4,642.9	59.1	0	40.9
21	CBC	$3,370.3	97.0	0	3.0
22	Alberta Public Service	$3,331.6	85.7	0	14.3
23	CAAT	$3,323.0	0	0	100.0
24	Alcan Aluminium	$3,322.0	14.8	0	85.2
25	Royal Bank	$3,093.0	0	97.3	2.7

Source : *Benefits Canada*, "The 19th Annual Top 100 Pension fund Survey", April, 1998

Alberta Local Authorities Pension Plan and the Alberta Public Service Pension Plan, form nearly half of the $33 billion Investment Management Division (IMD) of the Alberta Treasury. IMD inception took place almost two decades ago.[13] Still another is the $5.3 billion New Brunswick Investment Management Corporation (IMC), a crown corporation set up in 1996 with a statutory mandate for allocating the assets of three public sector pension funds, including the New Brunswick Public Service Superannuation Plan and the New Brunswick Teachers Pension Plan.[14] Like the Caisse de dépôt, several of these entities aggregate and invest other public monies as well.

These and other models suggest something of the investment power that Canadian public sector pension funds have attained in capital markets located in regions, nationally and worldwide. Presumably, this has been accompanied by the efficiency gained in scale economies and substantially reduced per plan operating costs than might otherwise be possible.

What does all of this growth betoken with regard to efficacy in the Canadian financial system? As Figure 3 reveals, employer-sponsored pension funds have certainly come of age as financial institutions, at least in terms of overall supply. In fact, they are this country's second largest pool of capital resources, after the banks. Increasing relative size and ubiquity in capital markets is a distinction Canadian pension funds share with their opposites in the industrialized economies of the United States, the United Kingdom, other European countries and Japan.

Incremental growth in the asset base of employer-sponsored pension funds shows no signs of halting or even slowing down. Of course, its extent and pace depend on the vicissitudes of Canadian and international economies and capital markets in the years ahead. Another key variable remains the going-to-market of still more plans in the public sector in future (along with the reconstituted Canada Pension Plan, expected to itself reach $125 billion within a decade). As a consequence, pension funds can reasonably be anticipated to expand beyond the $600 billion mark before, or not long after, the year 2000 with some restructuring-driven growth still to come.

Mechanics of pension governance

Issues pertaining to the governance of multi-stakeholder pension funds have come to fore in recent years. In their 1998 book *Pension Fund Excellence: Creating Value for Stakeholders*, Keith Ambachtsheer and Don Ezra hint at the reasons why, among other things, few funds have adopted current mission statements or clear enunciations of long-term goals and organizational strategies. Lack of direction and transparency at this level, say the authors, may well be the tip of the iceberg in some cases.[15]

Recently, PIAC sought to correct this situation by crafting guidelines for model governance principles and practices (*Effective Pension Plan Governance*, 1997). Guidelines address such key areas as the selection and function of governing fiduciaries (i.e., trustees), power-sharing between trustees and managers, and procedures/techniques for investment performance monitoring, review, reportage and evaluation.

Irrespective of their multi-various institutional designs, legal status ensures some commonality in the Canadian pension plan universe. Plans registered under federal or provincial regulatory regimes and Revenue Canada must comply with pension standards legislation in a given jurisdiction as well as the federal *Income Tax Act*. These requirements are matched by incentives — registered arrangements automatically entitle employees to tax-free plan contributions, while the registered plan's investment earnings are also permitted to accrue without taxation.

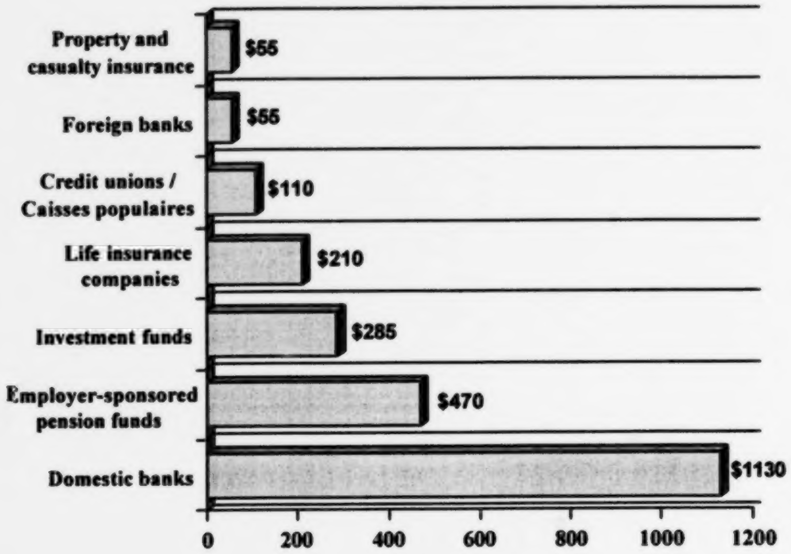
As the chosen funding mechanism of most pension funds, the trust agreement gives clarity to that most critical of phrases: "fiduciary responsibility." The trust frames the exercise of this obligation in a relationship between individual fiduciaries/trustees (at least three, one of whom must be at arm's length from the sponsoring employer), or a trust company, holding title to pension assets, and plan members (i.e., participating employees and retirees). In other words, fiduciaries owe loyalty to plan participants and beneficiaries and are legally answerable to them for all aspects of long-term pension administration, benefits funding, investment and management of assets.

Categories of fiduciaries and their respective duties can be further delineated. At the top, there are governing fiduciaries that, according to legislation in a given Canadian jurisdiction, act as the official plan administrator. In general, these tend to be the sponsoring employers or specific pension boards and committees of diverse compositions.

In the case of single employer pension plans in the private sector, it is usual for corporate boards of directors to delegate administrative decision-making to a sub-committee. In the case of multi-employer plans, this role is instead filled by a joint trusteeship process of equal numbers of employer and employee representatives (or, in some instances, the latter alone) that frequently emerges from collective bargaining agreements. Plans in government and the public and para-public sectors may observe some version of these two approaches.

Figure 3
Selected Canadian Financial Sectors, by Total Asset Size, 1997

($ billions of dollars)



Note : In 1998, the asset base of domestic banks was over $1.2 trillion while that of pension funds was over $500 billion.

Sources : The above numbers are end-of-year approximations derived from the *Bank of Canada Review* 1997-98; Statistics Canada's *Quarterly Financial Statistics for Enterprises*, 1998 and *Quarterly Estimates of Trusteed Pension Funds*, 1998 and national sector associations. The CLMPC acknowledges with thanks the contribution of Jean-Guy Bourgeois.

In all circumstances, governing fiduciaries usually hire agents or "managing fiduciaries" responsible for strategic implementation and oversight of policy decisions made by them. Such persons frequently assume the full-time, skills-intensive work that governing fiduciaries cannot, such as hands-on management of the portfolio, staff and external relationships.

In most Canadian jurisdictions, trustees who are sponsoring employers are required to add an advisory committee to pension governance structures — upon request by a sufficient number of plan members — where input from the latter does not otherwise exist. Few such committees have been established in practice, however. The exception is Quebec where 1990 legislation created a uniform and jurisdiction-wide framework for governance that includes mandatory committees occupying the administrative role. Such committees must consist of at least two representatives of plan members (active and non-active) and one person independent of both the employer and employees. There is no limit on sponsor appointees.

The managing fiduciaries accountable to governing fiduciaries will often further hire agents or "operating fiduciaries" charged with specific administrative assignments executed on a daily basis. These may be investment managers with expertise pertaining to certain asset classes or custodians who retain assets, settle transactions and keep records. A pension fund's relative size, as well as the scope of its portfolio of assets, often determines the commensurate magnitude of its fiduciary bureaucracy and whether it is located internally, externally or both. Non-fiduciary agents who act in advisory and service capacities include actuaries, lawyers and investment consultants.[16]

Labour participation in decisions

By all accounts, there is mounting interest in Canada's labour movement for a more substantial role for workers and their elected representatives in pension governance. Traditionally, this has been a priority for many private and public sector union leaders who have argued that it is their obligation to represent pension plan members who are also union members and negotiate crucial decisions about benefit values, funding policy, indexation and surplus issues. Over time, this priority has broadened to encompass the topic of investing and managing pension assets.

Above all, many Canadian unions, union centrals and union locals seek greater employee/plan member inclusion and input in pension investment decision-making processes and structures. The CLC and some of its provincial affiliates have made this a more explicit aim. This is also true for several national unions, such as the Canadian Union of Public Employees, the Communications, Energy and Paperworkers Union of Canada, the National Union of Public and General Employees and its provincial affiliates, the United Steelworkers of America and the Service Employees International Union. For them, this may be termed a "threshold" issue, meaning that it must be resolved before a labour voice in investment decisions can be adequately heard.[17]

At present, the participation of Canadian unions and workers in decision-making relevant to all aspects of pension governance is limited. Fiduciaries in only four of the 100 largest pension funds in the country characterize theirs as wholly union-directed (more exist in the category of below $1 billion in total assets).[18] Though incidence of joint trusteeship has certainly grown since the 1980s, the sharing of governing fiduciary roles and responsibilities between employers and employees remains largely confined to multi-employer funds in the private sector and a handful of large public sector funds (where an employee's contributory status is more pervasive).

In addition, while Canadian legislative jurisdictions provide for some measure of employee/plan member control on advisory committees to governing and managing fiduciaries, such bodies tend to be highly unsatisfactory to labour. This is due to such perceived structural defects as inception requirements, the low number of requisite employee/plan member representatives and the fact that member selection is not always under the direct control of those being represented. This complaint is also heard from labour in Quebec, despite its more rigorous system of broad and mandatory institutional coverage.[19]

This said, some pension advisory committee arrangements are notable for having been organized to function fairly well. In British Columbia, for instance, a bona fide joint process is underway. This includes equal numbers of employer and union appointees, with an independent chair, who are regularly consulted by trustees for large public sector pension plans and their money management institution — OCIO — in the province. A similar model is observed in Nova Scotia. It should be added, however, that some unions involved in these bodies, such as the British Columbia Government Employees' Union, though supportive, have registered a preference for implementing joint trusteeship.[20]

In another example, the presidents of the Fédération des travailleurs et travailleuses du Québec and the Confédération des syndicats nationaux sit as directors to the Caisse de dépot.

Not all Canadian unions place as much emphasis on influence over the investment and management of pension assets, at least with respect to advisory bodies or joint administrative arrangements, including joint trusteeship. This includes some unions affiliated with non-contributory, private sector pension plans. Alternatively, others exert control through the collective bargaining process. Where it is deemed necessary or beneficial, such direction can extend to specific investment decisions. A good example involves the National Automobile, Aerospace, Transportation and General Workers Union of Canada, or the CAW, who, in 1993 negotiations with Chrysler Canada, obtained agreement on an over $2 million pension asset allocation to co-operative and non-profit housing development in Ontario, subject to government fiscal partnership.[21]

Recognizing the importance of this topic to them, the CLMPC met with and interviewed union elected officials, staff and trustees over the course of research. In addition, the CLMPC participated in several CLC-sponsored forums (e.g., the "Jobs Now!" conference of February 18-20, 1998 in Ottawa) and initiated a roundtable of senior union representatives (June 23, 1997, Ottawa) to discuss a wide range of Canadian pension investment issues, including labour's role in determining outcomes of these. Later that year, the CLMPC agreed to work co-operatively with OPSEU to conduct a first-ever survey of Canadian labour trustees and representatives to advisory bodies associated with large private and public sector pension funds.

OPSEU survey research is a key initial step towards better comprehension of the needs and aspirations of Canadian labour trustees, advisors and their unions with respect to pension governance and investment decision-making. In particular, it yields new information about labour viewpoints on what constitutes effective and equitable joint trusteeship and other input bodies, the structural defects that may impede existing models and the resources required to facilitate enhanced labour participation in future.

Surveying Labour's Interest

OPSEU has for many years promoted the extension of worker participation in pension investment decisions that affect them, the economy and society. For this reason, the union collaborated with the CLMPC to produce the *Survey of Union Pension Trustees* to gain more understanding about the incidence of joint trusteeship and other conduits for labour input in pension governance. One of the first of its kind, this survey addressed questions to labour trustees and representatives of employees and plan members serving on advisory committees to twenty-three of Canada's top funds. The following is a brief summary of key findings.

- ✓ While labour input in Canadian pension investment decision-making is limited overall, it is more pervasive among the very largest public sector plans;
- ✓ Eight structural variants of labour representation in pension governance were identified in the twenty-three funds, from fully joint trusteeship to representation in an advisory capacity to little or no formal involvement in decisions;
- ✓ Full and official joint trusteeship (equal numbers of employee and employer appointees, sharing of top positions) is found to be best reflected in plans for the Alberta Public Service, the Colleges of Applied Arts and Technology, HOOPP and OPSEU Pension Trust;
- ✓ Official joint trusteeship exists in five other large public sector pension plans, but models vary according to administrative details that shape labour participation;
- ✓ Several public sector pension plans (e.g., in British Columbia) function with advisory committees with equal labour membership, but may be moving to joint trusteeship;
- ✓ Most large private sector pension plans have little or no formal representation by labour at the level of boards of trustees;
- ✓ Unions select labour trustees in five public sector pension plans or recommend nominees to the employer or government in others, while this practice varies in advisory structures;
- ✓ Most models involving labour include the latter's input in investment decisions, though a role in selecting and monitoring pension managers is more restricted;
- ✓ There is increasing labour interest in advancing joint trusteeship and other forms of employee/plan member influence in Canadian pension governance (especially among public sector unions) as well as trustee education, more union networking and resources devoted to labour-related concerns, and asset-targeting strategies that promote jobs, local development and other economic and social priorities.

Source: Carmichael, Isla, *Survey of Union Pension Trustees*, OPSEU, July, 1998; OPSEU, *The Power of the Purse* and *Policies on New Ways of Organizing*, 1998

Using OPSEU survey findings, the CLMPC has estimated that, in 1998, approximately one-third of total Canadian employer-sponsored pension assets fall under some version of jointly-trusteed administration. This is a minimum level, based on the assets of the top public sector funds identified in the survey combined with those of several of the largest multi-employer funds in the private sector. On the other hand, such funds are a minority in Canada's 3,500-fund universe. It also should be added that not all joint trusteeship models identified here enjoy the unqualified endorsement of labour participants.

Investing for the pension promise

Quite simply, all policies and processes for investing the assets of pension funds originate with the promise to plan members of retirement income and the strategies chosen to reliably meet that promise. Pension fiduciaries — governing, managing and operating — must plan carefully for the timely delivery of promised benefits, both current and future, and take steps to account for all knowable pitfalls that can throw otherwise guaranteed obligations off track.

To accomplish this, a sound investment policy is one that is intimately linked with its funding policy — or the decision about the rate of contributions made — as assets must be accumulated methodically to provide for immediate or long-term benefit payments to retiring employees. Put another way, plan assets (i.e., contributions plus investment revenues) are required to cover plan liabilities (i.e., outlays to beneficiaries). This is one way of describing the burden of investment policy since, as research has demonstrated, earnings from the strategic allocation of assets outweigh contributions as a source of plan revenue by a ratio of 80:20.[22]

In formulating investment policy, fiduciaries generally consider what is the minimum level of assets need to achieve full funding of the pension promise. They look for an appropriate balancing of assets and liabilities. Depending on the time horizons for maintaining this balance, fiduciaries develop a formal investment statement for the pension plan (i.e., the Statement of Investment Policies and Goals). At the heart of this policy is the asset mix that effectively defines all key investment imperatives, such as financial return objectives, diversification and risk parameters.

Trustee concerns about the funding status of a pension plan sometimes dictate a more conservative investment stance. If the funded portion of a plan is expected to cover liabilities for only a short period of time (e.g., a few years), its asset mix is likely to be significantly different from a plan with liabilities that stretch into the long-term. Concerns about the prospects of under-funding, or inadequate minimal assets in balance with anticipated liabilities, may require that pension asset allocations be altogether risk averse.

Conversely, in secure funding circumstances, strong earnings from a widely-diversified investment portfolio can ultimately relieve any pressures on a pension fund's contribution base (e.g., declining contributions due to declining employment levels) and reduce operating costs. This suggests a potentially higher degree of risk tolerance. In a good position to emulate this quality may be large defined benefit plans with long-term liability considerations. Plans such as these may possess, like some other institutional investors, the capability to be patient investors in a broad mix of assets classes (and capital markets) with the goal of realizing risk-adjusted and cost-adjusted returns over time.

The role of regulation

Trustees do not approach lightly the complex task of translating funding policy into investment policy and strategy. Neither do other pension fiduciaries with related decision-making powers. The obvious reason, discussed in the previous section, is that Canadian pension standards legislation, in the federal and provincial jurisdictions, holds these individuals responsible for the prudent administering of assets. Under the law, pension fiduciaries have explicit and enforceable duties in relation to plan participants and beneficiaries whereby the interests of the latter are the only consideration in decisions, including investment decisions.

With regard to investing pension assets, Canadian law of the past was especially detailed, prescribing strictly what allocations could and could not be made and under what conditions. Beginning in 1987 with the *Pension Benefits Act* of Ontario, regulatory frameworks across the country were gradually revised to make the investment decision-making process of fiduciaries more broadly, if no less stringently, guided by the "prudent person rule." Generally speaking, this rule states that a fiduciary must exercise care, diligence and skill in her or his decisions as one person might in handling another's property under common law. The prudent person rule is now the central underlying theme of pension regulation and supervision in Canada, as it is in Australia, New Zealand, the United Kingdom and the United States.[23]

Under this rule, the process by which an investment decision gets made is the central focus, and not strictly the outcomes of that decision. This means that pension fiduciaries can and should be judged according to whether they exhibit the legally-ascribed qualities of prudence as they allocate and manage assets with reasonable expectations of returns. By extension, they cannot necessarily be held accountable for poor returns resulting from unforeseen market circumstances or sheer bad luck, unless it is apparent that imprudent fiduciary behaviours led to this end. Put another way, the prudent person rule will be deemed fulfilled f, throughout the hierarchy of roles and responsibilities among trustees and their agents, attention has evidently been paid to cautious, informed and transparent decision-making.

Legislating for Prudence

The *Canadian Employment Benefits and Pension Guide*, published by CCH Canadian Limited, notes that the first step towards modern standards legislation for employer-sponsored pension funds came with enactment of the *Pension Benefits Act* of Ontario in 1965. This statute was intended to take stock of evolutionary changes in the country's retirement income system in the early 1960s, including inception of the Canada Pension Plan and the Fonds du Régime de rentes du Québec. Over the years, all other government jurisdictions amended or introduced legal provisions in harmony with those of Ontario, beginning with the *Supplemental Pension Plans Act* of Quebec, also in 1965.

In was not for another two decades, however, that Canadian statutory frameworks were again revised to incorporate the common law concept of the "prudent investor" or the "prudent portfolio" — otherwise known as the prudent person rule — in relation to the allocation and management of pension assets. The following is CCH's synopsis of the precise meaning of this concept as it is embodied in Section 58 of the *Pension Benefits Act* of New Brunswick (1991):

"The administrator of a pension plan must exercise "care, diligence and skill in the administration of a pension fund that a person of ordinary prudence would exercise in dealing with the property of another person." This is known as the prudent investor rule. If the administrator has professional or specialized skills, then the administrator must apply the relevant knowledge that the administrator possesses or "ought to possess" by reason of his or her profession, business or calling to the management of pension funds.

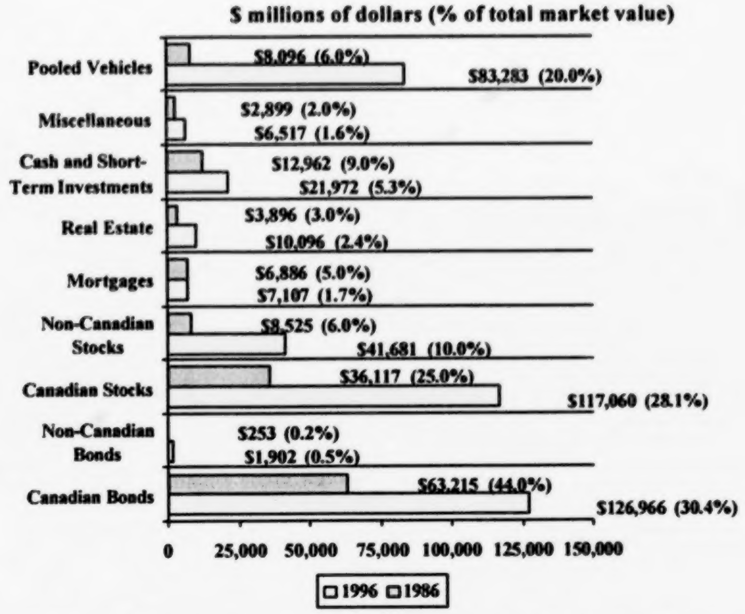
The rules regarding the prudent investor apply to members of a pension committee or board of trustees that is an administrator.

Where it is prudent and reasonable to do so, the administrator may appoint an agent to assist in the administration and investment of pension funds. If the administrator decides to appoint or employ an agent to assist in the administration of the pension fund, then it is the responsibility of the administrator to personally select the agent and to satisfy his or herself that the agent is suitable to perform the delegaged tasks. Once the agent has been appointed, the administrator must "carry out such supervision of the agent as is prudent and reasonable." The agent so appointed is under the same obligations of the administrator to avoid conflicts of interest, act as a prudent person, and apply the relevant skill and knowledge that a person in their profession ought to possess to their assigned duties. Any person engage in the investment of pension funds must ensure that those funds are invested in accordance with the *Pension Benefits Act* and regulations."

Comparable wording is found or referenced in legislation in other provinces and the federal *Pension Benefits Standards Act*.

Source: CCH Canadian, Ltd., *Canadian Employment Benefits and Pension Guide*, 1998

Figure 4
Investment by Canadian Pension Funds, by Asset Class (at Market Value), 1986 and 1996



Source : Statistics Canada, *Trusteed Pension Funds, Financial Statistics, 1996*, May 1998

Along with the prudent person rule, Canadian regulatory regimes spell out supplementary requirements of pension investment activity. For purposes of diversification, no more than 10 percent of a fund may be at risk in the assets of any one company or person. Neither may a pension fund own more than 30 percent of the voting shares of any one corporate entity. Foreign security holdings in a portfolio are also limited by the law, currently at a level of 20 percent. Among other strictures are those that cover investing in specific asset classes (e.g., real estate).[24]

From investment policy to strategy

There appears to be a consensus among Canadian pension fiduciaries and experts that the original decision rendered by trustees about which asset classes best suit the investment policy of a given plan is by far the most vital. From this decision, flow all subsequent decisions concerning investment strategy.[25] All pension funds tend to favour investing in similar core asset classes, such as stocks and fixed income, and similarly project and gauge performance according to established market benchmark averages and indices (e.g., the TSE 300, the Scotia McLeod Universe Bond Index). There are, however, different strategic routes to obtaining capital appreciation and returns. There are, for instance, active and passive styles to approaching asset management.[26]

Active management refers to pension investing that seeks to beat financial benchmarks by "picking winners." Tactically, this involves fiduciaries diversifying widely, trying to correctly read intelligence in a given capital market and being prepared to re-align portfolio exposure to assets when trends suggest new earnings potential. Passive management refers to pension investing in pools that replicate a stock or bond index or where portfolio exposure is otherwise geared to reflect a specified benchmark.

Of course, the active strategy for allocating and managing assets implies higher risk and possibly higher returns, while the passive implies lower risk and possibly lower returns. These respective, conventional characterizations have recently been the subject of considerable dispute as several research studies have shown low-cost indexing to yield robust financial performance, especially in bullish public securities exchanges. Regardless, pension funds can be grouped according the to extent to which they combine these two investment management styles or prefer one to the other within a portfolio. Today, there is more active management of Canadian pension assets (e.g., stocks) as compared to the United States.

It has been argued that the active strategy thrives where there is relative inefficiency in capital markets. It is in this environment that the experience, skills and applied techniques of a manager familiar with the functioning of a certain asset class provides an edge. Passive strategy adherents might argue in response that particular knowledge and craft is less meaningful in mainstream North American capital markets featuring liquid securities where publicly-available pricing data ensure efficiency. The capacity to add value through specialized, management-intensive investment may be more relevant in somewhat less efficient segments of these markets, such as small-cap public equity of less than $1 billion (though passive proxies are also on offer here).

For the purposes of long-term investment strategy, pension fund organizations can be structured in multiple, innovative fashions. To implement and administer a strategic plan for the portfolio, governing fiduciaries must identify and agree upon an appropriate fit concerning teams of managers, agents and advisers. Depending on size, available resources and other factors, teams may be situated within the pension fund (or, in the case of some private and public sector funds, their money management institutions), externally or both.

Naturally, very large pension funds frequently try to acquire reputable management personnel with different or complementary skill sets and locate them in-house to gain the advantage of maximum control over operating costs, flexibility, technical direction, monitoring and performance assessment. As the *Benefits Canada* survey of the Top 100 Pension Funds indicates, however, this is no uniform pattern among large peers (see Figure 2). For assorted reasons, some large funds prefer an investment strategy that utilizes external balanced and specialty money managers. Not suprisingly, this is the only option for the majority of pension funds that are small or medium-sized.

The balanced money manager undertakes diverse asset allocation tasks on behalf of pension clients based on their individual policy prescriptions. Alternatively, pension funds may select an array of management firms that can give concentrated and specialized attention to asset classes or sub-classes that are market-specific (some multi-product balanced management firms also house this capability). Distinct financial specialization can effectively address niche investment activity, from small-cap stocks to emerging capital markets in the global economy. Whichever the pension client selects — balanced, specialty or a mix of money management styles and companies — different approaches will place different demands on the pension fiduciaries who must oversee and evaluate external performance.

Active asset management and specialization are watchwords when a pension fund attempts an above-average risk-earnings ratio through portfolio diversification into the illiquid transacting of private capital markets. In these, relative inefficiency may be taken for granted (see **Pension Participation in Selected Capital Markets**, page 23) and there is an obvious need for qualified, value-adding management professionals (situated internally or externally) who can negotiate inherent costs and risks.

Pension participation in private capital markets is often described as investing in alternative or non-traditional assets and usually entails modest dollar amounts found at the extreme margins of portfolios. Illustrations include term lending, venture financing and other forms of privately-placed debt and equity. While real estate is a more traditional asset class for pension funds, it also constitutes a small portion of total asset allocations due to its predominantly private and illiquid nature.

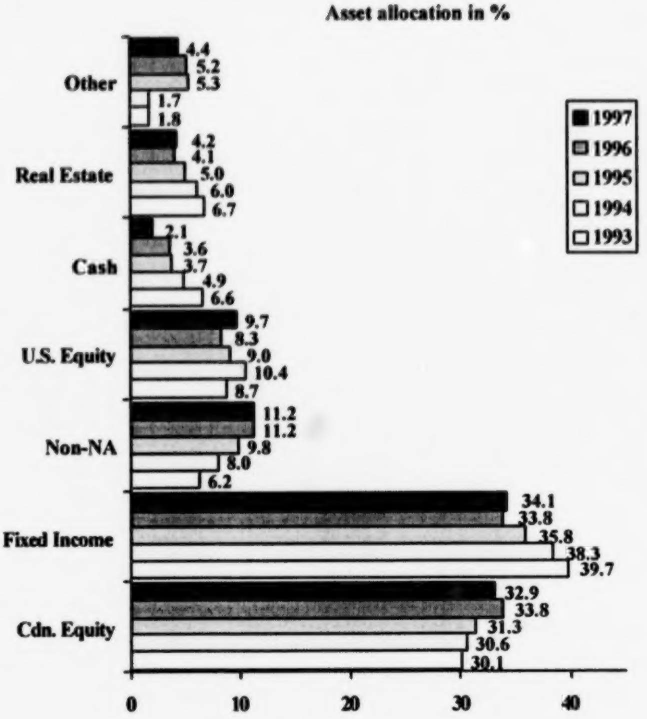
Trends in pension investing

Statistics Canada profiles of pension funds have included investment data and analysis over a forty-year period. Such information is also provided for the largest funds in the nineteen annual surveys published by *Benefits Canada*. Both sources highlight long-term portfolio shifts among the core asset classes, such as stocks and bonds, both domestic and international, as well as mortgages, real estate, cash and short-term investments. Because of comparatively low levels of exposure to them (e.g., less than 1 percent), alternative or non-traditional assets (with the exception of real estate) tend not to register as items for precise and systematic reportage.

Figures 4 and 5 illustrate some of the major directions taken, and long-term patterns seen, in Canadian pension asset allocations, in aggregate, since the mid-1980s. Three essential developments stand out with respect to the sources of investment earnings, and from an economic perspective.

The first of these is heightened pension exposure to public equity investing. According to Statistics Canada, bonds represented by far the biggest proportion of total assets (over 44 percent, at market value) a decade or more ago, but fell to just 31 percent by 1996. Today, direct investment in stocks, at over 38 percent, has replaced bonds in pre-eminence. If Statistics Canada estimates of indirect investment (including foreign holdings) are incorporated, this level moves closer to the 50 percent mark.[27] *Benefits Canada* data paint a similar picture in the public equity holdings (both national and international) of large funds. At the end of 1997, this level was almost 54 percent.[28]

Figure 5
Investment by the Top 100 Canadian Pension Funds, by Asset Class, 1993-1997



Source : Benefits Canada, April, 1998

Neither data source provides a breakdown of pension holdings of stocks by market capitalization size classifications (e.g., large-cap versus small-cap) utilized in Canadian public securities exchanges (see **Pension Funds and Public Equity Investing**). This is unfortunate, considering the unique qualities of what some fiduciaries regard as a separate or special equity sub-class in small-caps.

While the public equity investing of Canadian pension funds is more substantial in of the 1990s, overall asset exposure remains lower than that of counterparts in the United States and the United Kingdom. In these countries, such investing is typically around 60 and 80 percent of total assets, respectively.[29] Some individual pension funds in this country, such as Ontario Teachers PPB, have opted for these comparatively higher thresholds. Others may be moving in this direction, such as the pension funds associated with the Caisse de dépot, heretofore restricted in public equity investing under provincial law.

A second development in pension investment is greater diversification into capital markets in the United States and overseas. As indicated before, Canadian law restricts pension portfolio assets held in foreign securities to 20 percent of the total. A few years ago, funds were nowhere near this level, however, as Statistics Canada and *Benefits Canada* report, this situation has changed. In fact, with an average foreign disbursement of 21 percent in 1997, targeted mainly to public equity securities, large funds may have exceeded the legal cap were it not for fiduciary use of derivative products to gain supplementary and indirect access to international financial returns.[30] Despite this, PIAC and its membership believe that existing curbs on foreign investment are untenable and should be removed by the federal government.[31]

The bullish, high-price stock-picking and low inflation of the mid-to-late 1990s that have shaped the recent investment preferences of pension funds also appear to have contributed to a somewhat reduced emphasis of alternative/non-traditional asset classes. In 1997, *Benefits Canada* reported that so-called "bottom-feeder" assets like real estate and venture capital were declining in pension fiduciary esteem and portfolio exposure, due partly to the new favour being shown to investing abroad.[32] The other reason for this development is the bad experience many of these pension funds had in private capital markets in the late 1980s and during the subsequent economic recession.

At the end of 1997, *Benefits Canada* estimates that just over $1.5 billion in assets of the largest Canadian pension funds flowed to venture capital and other forms of private debt and equity placement. Of course, this represents less than a fraction of one percent of the total for that year. As Figure 5 shows, real estate captured 4.2 percent of the total in this same category of funds. Not completely captured in this or Statistics Canada survey data is a modest upswing in pension asset allocations to these alternative/non-traditional asset classes, beginning in small increments in 1997 or one or two years earlier.[33]

Pension investing and the economy

What is the connection between current patterns in pension asset allocations and change taking place in the Canadian economy? Of course, this is a big and multi-faceted topic that should be discussed with careful rumination about the numerous avenues by which pension investing in capital markets ultimately intersects with economic developments over long periods. However, the following may be regarded as something of an introduction to this much more expansive debate.

As indicated in the data of Statistics Canada and *Benefits Canada*, pension funds are pre-eminently creatures native to public securities exchanges. In the immediate past, when funds expressed their strongest predilection for fixed income assets, a role was carved out for them in the public market for corporate bond issues. Exponential growth in pools of pension capital in the late 1980s and the early 1990s was accompanied by exponential growth in this capital's exposure to corporate equity issues. This critical shift in the bond-to-equity ratios of funds has given them an unprecedented position both as institutional lenders and as institutional equity investors in exchanges.

This is no minor unfolding-of-events. In a brief time, Canadian pension funds have established a clearly interactive relationship with publicly-listed and traded corporations and periodic offerings that can yield the sort of productive investment that creates economic growth and employment. Funds may now be able to contribute all the more meaningfully to the supply of adequate and affordable public equity capital that is vital to business investment in Canada. This is also one of the reasons why pension funds are under pressure from different directions to clarify their dispositions as significant minority shareholders in blue chip enterprises and on a wide range of corporate governance issues.[34]

At the same time, what is troubling in the current Canadian economic context is the investment financing barriers that are encountered by new and developing SMEs, emerging knowledge-based and technology-intensive firms and traditional firms attempting a transition in an altered competitive environment. Is there a "disconnect" between demand from these sources and supply of pension assets, perhaps illustrated in reduced exposure to alternative/non-traditional asset classes and the private capital markets in which they are situated? Are pension funds fully represented across the national private-public market continuum for financing business with new economy imperatives? If not, why not?

The contemporary Canadian employer-sponsored pension fund exhibits integral attributes that suggest a ready fit with certain roles as active and leading financial agents in a changing economy. As previously discussed, the fiduciary effort to appropriately balance assets in portfolios with benefit liabilities down the road means that these funds are characteristically patient in their approach to investing. Along with a long-term mandate, the fiduciary requirement to diversify asset mixes may also eventually invite still broader capital market participation, especially as assets persist in accumulating.

These and other qualities of pension funds towards the end of the 1990s explain why some are charting a new and substantially different investment course.

3. Pension Participation in Selected Capital Markets

Four Canadian capital markets

The following sections — **Pension Funds and Venture Investing, Pension Funds and Middle Market Investing, Pension Funds and Public Equity Investing** and **Pension Funds and Real Estate Investing** — look at four capital markets that contribute quite significantly, if in very different ways, to broad and specific developments in Canada's economy and employment base. An additional criterion for selecting these capital markets is that, to a greater or lesser extent, pension funds participate in all four, at home and abroad.

The first three form what may be characterized as a private-public market continuum for capital supply to new and developing SMEs and larger firms in both traditional and non-traditional Canadian industries. As an individual SME grows, its relative access to adequate and affordable external financing will vary according to its own intrinsic structural qualities, especially the critical qualities of size, age and establishment in the commercial world (see Figure 6).

This financing continuum has seen increasing use in recent years, especially as growth-oriented SMEs (or so-called "gazelles") in knowledge-based and technology-intensive industries have come to the fore. A good example is Vancouver-based Ballard Power Systems, the developer of a non-polluting fuel cell engine technology, that began as a 1989 start-up financing in the venture capital market and, following initial public offering in 1995, has since advanced to the top of public securities exchanges. Ballard's workforce has expanded commensurably. Other examples are alluded to in the pages to follow.

A factor of equal importance to determining access to financing is the relative strengths and weaknesses of those capital markets and market segments that the expanding SME may require on its progress. As several Canadian and international research studies have demonstrated in recent years, there are serious and substantial gaps in the financing continuums of national economies. Despite their increasing importance to fostering economic change and restructuring, several of the capital markets plotted in Figure 6, or segments of these markets, remain small, undeveloped or not-fully-developed relative to business financial demand needs. This is even more true in sub-markets in certain community and regional economies. Key to improving circumstances in many of these is consistent supply of sufficient magnitude and infrastructure that addresses identifiable market weaknesses.

A word about private capital markets

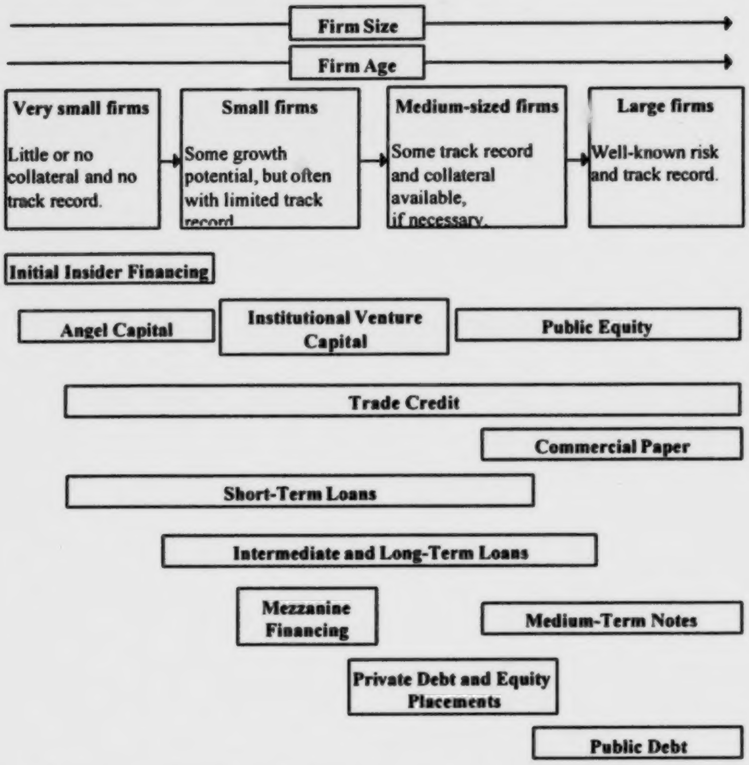
This is most necessary in the case of private capital markets — SME loan markets, institutional venture capital, mezzanine financing and other markets for private debt and equity placements — which are clearly structurally inefficient. The basis of private capital market inefficiency is its information intensity, meaning that the suppliers of capital must obtain their own data about SME demand through direct or indirect collection, due diligence and on-going investment management and monitoring. This is in contrast to public markets where government regulation ensures data disclosure that, in turn, establishes a reliable pricing mechanism and raises transactional efficiency. Because they are information-intensive, transacting in private capital markets is very often complex, costly and risky and depends more heavily on the value-added that experienced investment specialists bring to them. In other words, information problems dictate creative, management-intensive solutions.

Investors and financial institutions in private capital markets, as well as advisors, agents and intermediaries that act on behalf of suppliers or SMEs, can be described as "market shapers" in that their long-term operations end up constituting market infrastructure. Insofar as they are sound and effective, such marketplace operations compensate for structural inefficiency. This means that inherent structural barriers are organizationally overcome to put investors in touch with potential earnings and to permit the economic potential of private capital markets — such as job-creating, high-growth SMEs — to be completely realized.

This is the burden of Canadian lending institutions, venture capital institutions, investment and merchant banks and other investors and financial intermediaries motivated by the optimal, high-yield returns that private debt and equity investing frequently promise, net of risk and deal-making costs. Very often, government-directed or government-sponsored financial institutions also enter local sub-markets or segments of private capital markets that are, for one reason or another, neglected or difficult to navigate and organize, at least initially.

Venture investing and middle market investing, as defined in this document, fit into the above-described private capital market matrix. So does real estate investing, for the most part. Naturally, public equity investing stands apart, but as **Pension Funds and Public Equity Investing** discusses, the relative smallness of Canadian public securities exchanges, and underdevelopment in certain exchange corners, suggests some relative, market-specific inefficiency. These are

Figure 6
SME Growth and Financing Continuum


Firm Size
Firm Age
Very small firms
Little or no collateral and no track record.
Small firms
Some growth potential, but often with limited track record
Medium-sized firms
Some track record and collateral available, if necessary.
Large firms
Well-known risk and track record.
Initial Insider Financing
Angel Capital
Institutional Venture Capital
Public Equity
Trade Credit
Commercial Paper
Short-Term Loans
Intermediate and Long-Term Loans
Mezzanine Financing
Medium-Term Notes
Private Debt and Equity Placements
Public Debt

Source : CLMPC - adapted from original figure for U.S. capital markets, Federal Reserve System, Washington DC, 1998.

very relevant to low-capitalization stocks (or small-caps).

Pension participation in the four

As the second-largest pool of capital in the Canadian financial system, the degree of attachment of employer-sponsored pension funds to these four capital markets is an important consideration. As outlined in the previous section, fast-growing pension fund sizes have over time led to moderately enhanced exposure to the alternative/non-traditional asset classes that, in most instances, reflect this participation. This development is rooted primarily in the attractions of above-average, risk-adjusted returns of some of these categories of assets that can be well in excess of traditional public stock and bond yields.

In the next sections, a brief overview of nature, scope and dimensions of these four capital markets is provided that includes mention of their essential function in supporting Canadian economic and job changes. In addition, historical and current pension investment activity in them is described and discussed. In some cases, plentiful data exist to highlight this participation, in others, little or no data is available for this purpose. As a consequence, details of current participatory models are also provided in individual case profiles. The extent to which pension investment reaches community and regional economic development is also briefly examined. Some early thoughts about the prospects of a heightened capital market presence by pension funds in future, as well as some of the framework terms and conditions under which this may occur, concludes each section.

4. Pension Funds and Venture Investing

The functions of private equity

Private equity investing can have many possible applications in a national economy, however, in research literature, such tends to be delineated according to two specific forms: venture capital and its non-venture counterpart. This is a somewhat arbitrary distinction, as the two share much in common. Both involve long-term equity participation in an enterprise with relatively ambitious market goals, such as expanding productive capacity. There is in all private equity illustrations some requisite investor involvement in investee firm decisions, exercised often through direct representation on boards of directors.

As shareholders, all private equity investors and their agents are also keenly interested in the strategic realization of an enterprise's long-term objectives. To varying degrees, venture and non-venture investment specialists are patient and pro-active in achieving this result. Over the lifetime of an investment, a firm may receive benefit of skills, experience, and a network of business contacts that prove invaluable to developing and advancing products in domestic and global markets.

In other words, the contribution of the private equity supplier is not just money. It is additionally the potential value-added of hands-on growth management that, in the end, leaves the investee firm with enhanced capability, competitiveness and productivity. This is particularly vital to young, knowledge-based and technology-intensive business where, in the case of venture financing, the personnel of the supplier institution possess related industrial expertise.

Venture and non-venture forms also both utilize debt-like instruments in investments to accommodate convertible or subordinated securities, et al. Generally speaking, private equity investing aims to generate income through appreciation of illiquid holdings and capital gains once holdings are disposed.

Different markets for private equity

The markets for venture and non-venture private equity can also be said to overlap, however, the two differ with respect to their primary investment targets. The focus of the former is on new, growth-oriented SMEs at various stages of development, such as seed projects, start-ups and early or late phases of expansion, to which the venture capital institution will offer support until liquidition of the equity stake by an initial public offering or acquisition. Venture financing may also back acquisitions, buyouts and turnarounds of slightly more established SMEs.

Such investment activity always carries high risk, sometimes because an SME's product idea is in its infancy or because firm assets are intangible and, consequently, are not seen as being suitable for conventional forms of secured financing (e.g., bank loans). These characteristics are clearly evident in the high technology venture. It could also be that the pace of enterprise growth is exceptionally fast. Generally speaking, the duration of venture investment projects is usually between three and ten years.

Non-venture equity is also disposed to high risk, but tends to concentrate on more sizeable investment deals and larger companies. A typical client is the private and well-established medium-sized firm situated in traditional goods and services industries. Another is the publicly listed large corporation engaged in especially complex transacting, such as a merger or acquisition, and for which private placement may provide the best outlet. The market for non-venture private equity is discussed in greater detail in the next section (**Pension Funds and Middle Market Investing**).

One way of capturing the not-entirely-clear distinction between venture and non-venture forms of private equity investing is by isolating their respective deal size preferences. In Canada, the current cut-off point has been estimated by market analysts and practitioners to be as low as $7 million and as high as $10 million, with venture capital assuming all or most disbursements below these thresholds and the non-venture version, those above. This estimate accords with several suggested for American private equity markets.[35]

Today in Canada, considerably more is known about the nature, dimensions and scope of venture capital than its non-venture counterpart due to extensive and on-going documentation by Macdonald & Associates, conducted partly on behalf of the Canadian Venture Capital Association. It is with the help of this database that the development of an institutional venture capital market can be observed as well as the historical and current role of employer-sponsored pension funds in this development.

Risk-taking in America

It has been estimated that well over half of venture investment activity taking place around the world is found in the United States. Consequently, the American market is viewed as a model for other industrialized countries in Europe, Asia and South America where such activity is usually non-existent, struggling or geared to the mainstream demand of large corporations. Interest is being expressed about the American market's apparent efficacy in supporting the growth of global high technology industries, such as computer hardware, software and system products in the 1980s, and today, in Internet-related goods and services and life sciences.

Much of the economic success of American venture financing is attributable to its links with sources of innovative ideas, including entrepreneurs, post-secondary education institutions, and government research laboratories. In Silicon Valley, California, the relationship between the market and new technology is especially synergistic. A leading actor is Kleiner, Perkins, Caufield and Byers (KPBC), a venture capital institution that emerged from the original Kleiner Perkins partnership of 1972. Among the over 370 such institutions operating across the country in 1998 (and over 600 partnerships and pools), KPCB has the enviable record of having facilitated the emergence of 100 now publicly-listed enterprises, with another eighty currently in progress. These include a disproportionately large share of venture-backed technology-intensive SMEs. In 1998, KPCB pooled capital stood at $1.2 billion.

Sufficient backing of KPCB and other institutions/pools is taken for granted in the American institutional venture capital market where pension funds have historically been the major source of supply. In recent years, and over the course of several cycles, such funds have been responsible for approximately 50 percent of new commitments to American private equity markets of all kinds — from venture financing to leveraged buyout activity. The consequence of cumulative supply from pension funds and other institutional investors to venture financing has been annual growth rates in the order of 25 percent and capital inflows that reached $10.3 billion at the end of 1997. A slight drop in pension supply to 38 percent registered at this time is attributed only to increased participation from other sources. At the beginning of 1998, venture capital under management exceeded $46 billion in total.

With regard to total assets allocated, the largest pension suppliers currently are CalPERS, Utah State Retirement Systems, Michigan Retirement Investments, Connecticut Trust Funds and NYNEX Corporation. Most of these names allude to yet another trend — the meteoric rise of public sector pension plans as suppliers to the venture capital market. In recent years, their participating opposites in the private sector have continued to contribute proportionally more money per plan (e.g., typically, between 2-4 percent of total assets and as high as 25 percent). However, the sheer size of public sector participants has given them a greater market presence, despite what have been more moderate per plan commitments (e.g., typically, between 1-3 percent of total assets). Evidently, the latter have also leveraged more sharing of venture disbursements to SMEs among American economic regions and states (see **Pension Funds and Venture Investing**).

Sources: KPCB, *Brochures*, 1998; *The Private Equity Analyst*, Vol. VIII, Issue 1, January, 1998; Office of Advocacy, US Small Business Administration, 1995; Venture Economics, *1997 Annual Report*, 1998

Venture investing and the economy

Canada may be considered fortunate in having a growing and increasingly diverse institutional venture capital market when, by all accounts, this is not the case in many advanced industrialized countries outside of North America. Perhaps it is not surprising that the Canadian market has evolved, sometimes unsteadily, in the wake of the vibrant American market. Indeed, it can be said that the Canadian venture capital market has benefited substantially over time from the lessons learned in earlier experience south-of-the-border.

The origins of venture investing in this country can be traced to the early 1950s, but a fully-fledged market did not appear until three decades later. By the early 1980s, total venture capital resources had climbed to over $1 billion and investment activity and infrastructure seemed to moving in a direction parallel to that in the United States. In several seminal reports produced during this period, however, Mary Macdonald pointed out that venture capital supply flows were too unstable to assist market development over the long-term and that certain structural problems impeded optimal investment. Key among the latter problems was a limited number of qualified and experienced venture specialists to manage pools.[36]

Despite the obstacles, the national venture capital market has progressed over the years. One of the reasons for this was the contribution of the federal and provincial governments to improving supply conditions, directly or though indirect vehicles such as labour-sponsored investment funds. Relatively constant capital flows permitted the market to evolve structurally to the extent that, today, venture investing is a much more dynamic activity than it was in the last decade.

At the beginning of 1998, total capital under management in the Canadian market had grown to $8.4 billion or a near doubling of available resources since the early 1990s. Augmented supply was, in turn, matched by unprecedented investment. In 1997, a total of $1.8 billion was disbursed to close to 800 companies, up 67 percent from the record high attained in 1996. Moreover, venture financing has reached a far broader range of SME demand in recent years. Due to a variety of factors, small dollar projects, start-ups and early stage transactions receive a bigger share of market disbursements than has historically been the case.

Perhaps one of the most meaningful trends in Canadian venture capital has been the heightened portion of investment activity directed towards growth-oriented firms in emerging technology-intensive industries. While they potentially represent new generations of employment for Canadians, new and developing high technology SMEs were the targets of less than half of total venture disbursements in the late 1980s. By the early 1990s, this level had declined to around one-quarter due to a perceived lack of quality in technology-related deals.[37]

By 1997, the high technology investing of venture capitalists had climbed to over two-thirds of total disbursements, finally besting the support shown to more traditional industries. Biotechnology, communications, computer products, electronics, environmental goods, industrial automation and medical-related technology are among the most favoured of knowledge-based sectors. Perhaps the estimable investment flows reaching the spectrum of life science industries and industry segments is the most dramatic trend, currently. Macdonald argues that this and related developments are due a maturing relationship in supply and demand. There is, she says, positive mutual re-inforcement occurring between strong resources and increasingly capable specialty management on the supply side and, on the demand side, more and increasingly sophisticated entrepreneurs. [38]

The rewards of venture investment to the national economy are out of proportion to the market's comparatively modest size. By undertaking financing of new business formations and high-growth SMEs not easily accommodated elsewhere, venture capital institutions facilitate gains to growth and jobs that replace the losses of economic restructuring. This is most apparent in the highly-skilled, highly-paid workforces of venture-backed technology firms, noted above. In the United States, such firms are credited with creating knowledge workers — engineers, management personnel, technicians, technologists and scientists — at four times the level of similar employment created by that country's top 500 publicly-listed corporations.[39]

1997 research published by the Business Development Bank of Canada reveals the cumulative economic potency of venture investing. Between 1991 and 1996, close to 17,000 jobs were created by 420 venture-backed companies at an exponential growth rate of 26 percent per year. Equally impressive annual growth rates in sales, research and development spending and exports were also reported.[40] Such outcomes outstrip performance in the rest of the Canadian economy by wide margins.

The Pension Difference Down-under

Like Canada, Australia is home to private equity markets that have occasionally had to struggle against setbacks, including those of the 1980s, before delivering a consistent stream of returns to investors and the economy. Also like this country, government in Australia has exerted its influence to bolster capital inflows and redirect venture investment to start-ups, early stage developments, high technology SMEs and transactions located in the regions. Unlike Canada (and more like the status quo in the United States), the predominant source of supply to these markets are Australian pension funds.

At the end of 1997, the Australian pool for institutional venture capital stood at over $1.6 billion, $744 million of which was directed to 307 investee firms (along with about $29 million in commitments). These data reflect substantial increases in the total capital under management in the market as well as investment growth rates over the 1990s. At present, around one-third of investee firms are technology-intensive, while somewhat less than one-fifth are situated in manufacturing and other exporting industries. SMEs form the vast majority. Eighty-six percent of all investing goes to expansion projects, 5 percent to start-ups and the balance to more mature, merchant banking-like deals (e.g., leveraged management buy-outs). Some of the top venture capital institutions are also active in New Zealand.

Providing the fuel for this rapid development are pension funds, bringing 72 percent of new supply commitments to the venture capital market last year. Moreover, the pension share in cumulative supply over time is 62 percent, followed by the banks at close to 15 percent. Among the most prominent of these have been jointly-trusteed, industry superannuation funds, a recently-established supplementary system to Australian employer-sponsored pension funds in the private sector. Industry funds have been responsible for well over half of all supply from this source with the largest of these now aiming to allocate between 3-5 percent of total assets. Public sector funds are the second largest group.

The participation of industry funds was significantly advanced in 1990 with initiation of the Development Australia Fund (DAF). This fund-of-funds was designed to pool pension assets for long-term investment through private capital markets that yields demonstrable collateral benefits, such as stimulation of economic growth and job creation. Interestingly, it resulted from a consensus arrived at by national business and labour organizations, including the Australian Chamber of Manufactures, the Australian Council of Trade Unions and the AMP Society. In 1997, DAF managed over $400 million in assets and operated a venture capital portfolio based on direct co-investments and commitments to externally managed sub-pools. Other mandated objectives include financing of infrastructure and residential housing.

Pension participation in venture and non-venture forms of private equity in Australia has been impeded by many of the same structural market barriers identified in Canada. To address these, effort has been put into developing pooling vehicles, such as DAF, and limited partnerships that respond to the needs and constraints of this institutional investor. There is also supply of, and demand for, gatekeeping intermediaries in the Australian markets, such as those found in the United States (see **What's a Gatekeeper?**).

Sources: Arthur Andersen, *AVCAL 1997 Survey of Venture Capital*, 1997; Coopers & Lybrand, *The Economic Impact of Venture Capital*, 1997; DAF *Annual Report*, 1997; Mathews, Iola (Rothschild Australia), *Regions, Capital and Job Creation*, 1998; CLMPC interviews

Pension funds and venture investing: then

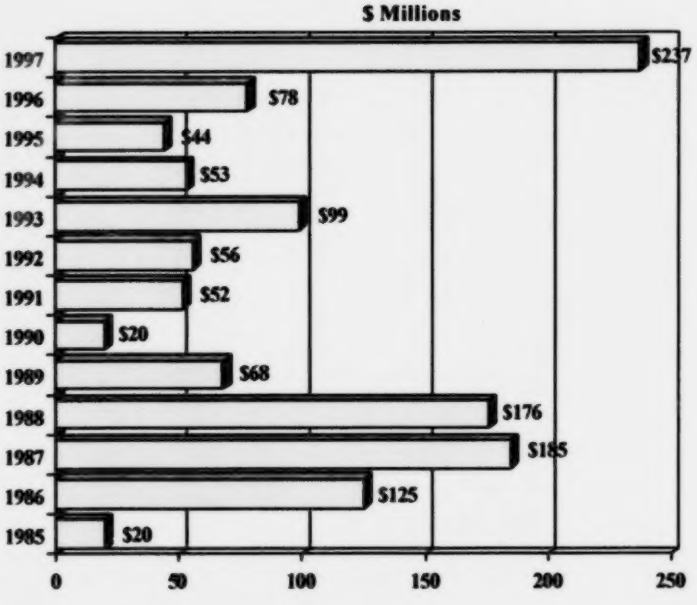
While in Canada employer-sponsored pension funds do not currently fill the prominent venture capital supply role evident in some other countries, this has not always been the case. In fact, Canadian pension funds occupied a very formative position in the market during the 1980s. At that time, when the market was in a state of transition, so too were pension funds. As was discussed in **Investing and Managing Pension Assets in Canada**, mid-decade witnessed the initiation of regulatory reforms that ultimately gave pension funds much broader investment powers. Government changes to the prudential framework were most meaningful to public sector plans suddenly able to participate in capital markets for the first time.

These and other trends helped to precipitate the entry of several private and public sector pension funds, such as those associated with BCE-BIMCOR, the Caisse de dépôt, Canadian National Railways Pension, Canadian Pacific Pension Fund and OMERS, into the venture capital market. For a brief spell, Canadian pension funds followed the path forged by those in the United States in providing indirectly, through limited partnerships, most new capital commitments. This is shown in Figure 7. Supply by pension funds peaked at $185 million in 1987, but plummeted thereafter, reaching a low of $20 million in 1990. Aggregate participation has tended to average about $50 million per year since then.[41]

While they were a major presence, pension funds registered considerable influence over the nature of transacting. Indicative of their tentative foothold, such influence nudged aggregate venture investment patterns of the late 1980s towards comparatively safe projects that were later stage (i.e., acquisitions, buyouts and expansions), more sizeable projects, and had little or no high technology orientation. If Canadian pension funds had stayed with the market, they may well have expanded the scope of their activity with time and greater confidence in an initially unfamiliar and underdeveloped environment. This is, at least, the historical pattern followed by pension funds elsewhere.

What caused the abrupt withdrawal of pension funds from the market? Certainly the economic recession at the end of the decade was an important trigger for them, as it was for large insurance companies and other institutional investors that similarly reduced their

Figure 7
Pension Fund Commitments to
Venture Capital in Canada, by Year, 1985-1997



Source : Macdonald & Associates, 1998

exposure to this asset class. Recessionary pressures were probably not sufficient, however, to sever the link entirely. CLMPC interviews with pension managers, market analysts and practitioners tried to identify supplementary factors. Responses proved divergent and occasionally conflicting.

One explanation offered by interviewees for the market pull-out of pension funds was that risk-adjusted returns were demonstrably substandard. This was immensely disappointing given the expectations created by consistently strong vintage year returns in the United States. Fault was also found in the externally managed pooling arrangements utilized by pension funds with regard to such variables as fee structures, overpricing of deals and poor communications with venture investment specialists that impaired fiduciary monitoring of on-going performance.

Other interviewees argued that pension funds were unprepared for the ebb and flow of illiquid investing. For this reason, some inflexible pension administrations may have been apt to overreact to immediate losses and neglect the longer-term realization of projected gains. Some also believe that government incentives of the 1980s — pre-eminently, the federal three-for-one tax rule whereby allowable increases in the foreign content of pension holdings were tied to assistance to SMEs — had the unintended effect of encouraging new market participation just prior to a cyclical downturn.

Regardless of these and other circumstances, the experience of the 1980s has itself become a barrier to any attempted market re-entry, considering the negative impact it had on the perspectives of many senior Canadian pension fiduciaries. A more thorough discussion of this and related current challenges is found in **Pension Barriers to Financing New Economy Investment**.

Pension funds and venture investing: now

Following the departure of many institutional investors, the composition of venture capital supply was altered. In the early 1990s, most Canadian governments intervened to restore flows, chiefly by providing tax incentives to labour-sponsored funds, such as the Fonds de solidarité des travailleurs du Québec (FTQ). Indeed, some venture capital institutions that had previously relied on supply by pension funds turned to this new source. Finally, after several years' absence, pension participation in venture investing witnessed something of a rebound in late 1997, also as illustrated in Figure 7.

In fact, 1997 marked a peak of new dollar commitments. This translates into 16 percent of total market supply in that year (see Figure 8) or a nearly threefold increase in what had been pension involvement in the years immediately preceding.[42]

Unlike the 1980s when pension participation brought together dozens of funds, the level reached almost a decade later reflects the activity of only a handful of very large funds. This includes veterans, such as the Caisse de dépôt and OMERS as well as the first-time entry of the public sector pension plans associated with British Columbia's OCIO and Ontario Teachers IPB. At the same time, other pension funds with holdings in pools originating in the 1980s have been recently liquidating these without, in the majority of cases, any subsequent follow-up with new commitments. Hence, while total pension dollar contributions may be going up, participation as measured by numbers of funds continues to decline.

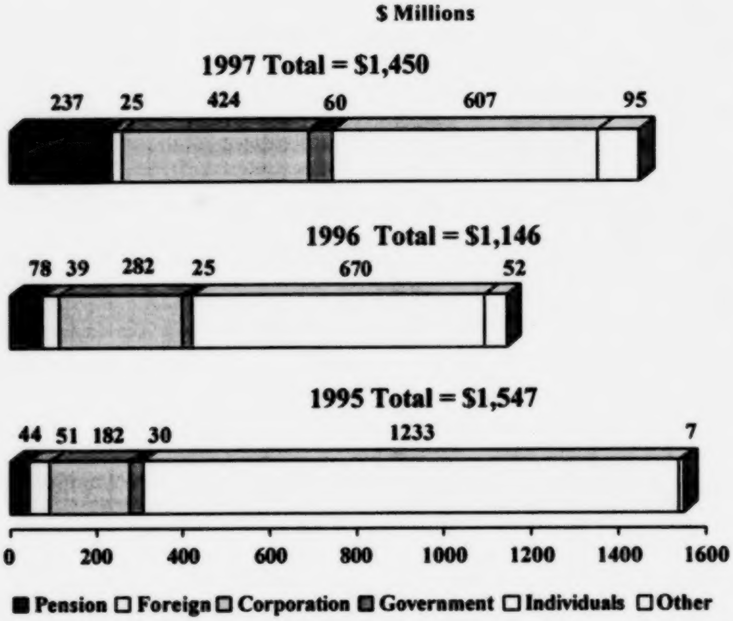
Using the database of Macdonald & Associates going back to 1985, the CLMPC estimates that current Canadian pension supply to the venture capital market totals approximately $800 million to $1 billion (or roughly 0.2 percent of total pension assets).

In practice, pension funds, both large and small, can participate in venture investing either directly, by co-investment with other financial institutions and pools — often on an individual project basis — and indirectly. Generally speaking, the indirect approach entails syndication of pension assets in a pooling vehicle situated externally, such as a limited partnership.

As mentioned earlier, indirect pension involvement through externally managed pooling and intermediation of the venture capital market is the most commonly-observed model. The most pervasive of all, the limited partnership, has demonstrated particular efficiency. This is because it allows pension funds and other institutional investors of all sizes to share the costs and risks of sometimes very small deals and sums and to defer the management-intensive tasks of finding, selecting, structuring and monitoring these deals to specialists. Given the finite supply of the latter with sufficient professional expertise to add investment value, pooling also permits multiple pension funds to take advantage of those available. For further discussion of this matter, see **Of Pools and Pooling**.

Both direct and indirect systems are in evidence in Canada. The following is an illustration of these, with particular reference to the return of pension funds to venture investing in 1997 or to activity that has been sustained without interruption since the 1980s, most prominently in Quebec.

Figure 8
Supply Sources of New Venture Capital in Canada, 1995-1997



Source : Macdonald & Associates, 1998

(1) Direct pension participation

An old and a new example of direct pension participation, the Caisse de dépôt and Ontario Teachers PPB, are presented here. The former is important to any discussion of venture financing in Canada given its long history in the market, beginning almost two decades ago. Unlike most other pension funds, the Caisse de dépôt persevered following the downturn at the end of the 1980s and accounted for most new capital commitments coming from this category of institutional investor until the mid-1990s.

The Caisse does not segregate internally-managed venture supply and portfolio investment. Rather, a number of different subsidiaries within the Caisse Private Investments Group, such as Capital CDPQ and Capital d'Amerique CDPQ, offer venture capital as one of several financing options for new and developing SMEs and frequently as part of a multi-layered transaction that utilize assorted debt and equity instruments. This is consistent with the overall Caisse strategy for facilitating business formation and growth in Quebec at all stages, from seeding to listing on public securities exchanges. Coupled with this investment focus is close the attention paid to specialized requirements, such as an SME's industrial context or product line, some of which may evolve over time (see **Caisse de dépôt: Ways and Means**).

Capital CDPQ and Capital d'Amerique CDPQ invest in growth-oriented SMEs situated in both traditional and non-traditional industries, with the former assuming relatively small deal sizes ($1 million and below), and the latter, somewhat larger ones (above $1 million).

Independent of these operations are Caisse subsidiaries featuring venture financing that is directed to certain knowledge-based and technology-intensive sectors. Capital Communications CDPQ invests in SMEs in communications industries, such as the Internet, multimedia, and assorted other telecommunications production, while Sofinov, Société financiere d'innovation focuses on those in biotechnology and health, information technology and industrial goods. Recently, Sofinov also initiated pools with seed financing mandates (see **From Acorns to Trees**). Both subsidiaries follow SME development across all stages, including those associated with the venture phase, such as start-up, early stage growth and rapid expansion.

In-house subsidiaries have also allocated a portion of assets to indirect and external management of selected pools, such as Miralta Capital (see below). Another is TechnoCap which also enjoys the support of Bombardier Pension Trust Fund and Regime de Rentes du Mouvement Desjardins. Diversification is one rationale for this approach, as is the Caisse objective to network with other venture capital institutions in the province.[43]

In all, Quebec-based venture investing under the auspices of the Caisse Private Investment Group totalled almost $500 million in 1998.[44]

Another example of direct participation is seen in a relationship initiated by Ontario Teachers PPB with Newbridge Networks Corporation. For several years, Newbridge has operated an affiliates spin-off program whereby new product ideas are nurtured internally to eventually create information technology start-ups and early stage firms. An essential part of this strategy is Celtic House International, a venture subsidiary capitalized in 1996 by Ottawa Valley angel investor Terry Matthews. Today, with $65 million available, it typically commits between $1-4 million per investment project.

Celtic House is an innovative Canadian model of what is called "corporate venturing", a concept pioneered worldwide by American and Japanese enterprises with respect to emerging high technology industries. Corporate venturing entails a large and well-established business entity providing a small and young one not simply money, but access to in-house experience, skills and networks of value to developing commercial and financial management resources and marketing strategies. Frequently, the target is an affiliated spin-off that can yield not only returns, but also a window on new products. In the case of Celtic House, spin-offs also benefit from Newbridge's collective expertise and position in global telecommunications.

At the beginning of 1998, Celtic House portfolio consisted of at least twenty-two investee firms, one of which — CrossKeys Networks (a communications software firm) — had already completed an initial public offering.[45]

As part of its 1997 decision to commit $100 million to venture financing, Ontario Teachers determined to partner with Newbridge and other financial institutions and investors on specific affiliated spin-off projects, including those of Celtic House. In general, the pension fund's Merchant Banking Group (see **Pension Funds and Middle Market Investing**) receives potential deals and conducts due diligence independently on each before deciding to participate. Currently, Ontario Teachers has a stake in as many as five Newbridge-related venture co-investments.[46]

(2) Indirect pension participation

Prior to the emergence of labour-sponsored funds, venture capital institutions known as "private independents" tended to dominate the market, in part because of their ability to attract pension money. Conversely, private independent supply was quite negatively affected by events at the end of the 1980s.

A major Canadian private independent with a long-term relationship with pension funds is Ventures West Management (headquartered in Vancouver). Established in 1968, this institution manages $290 million in venture capital pools, $220 million of which is targeted to young knowledge-based and technology-intensive firms in such sectors as biotechnology, communications, computer software and systems, electronics, energy and environmental products, industrial goods and medical technology. Ventures West has been responsible for bringing some of the country's most successful new commercial enterprises from start-up to public offering, such as Ballard Power Systems and StressGen Biotechnologies.

Among Canadian venture capital institutions, Ventures West applies a remarkably early focus to growth-oriented high technology SMEs. Over 80 percent of its past and current universe of investee firms reflect early stage transactions, the lion's share of which are seeding projects and start-ups. This focus is also indicated in Ventures West's financing range of $300,000 to $5 million. Indeed, with the support of pension assets, Ventures West recently initiated two first-ever pools with seed financing mandates in Canada (see **From Acorns to Trees**).

Over its history, Ventures West has collaborated in limited partnerships with approximately 100 pension funds. Consequently, it felt their absence in recent years, despite having other supply sources. This situation changed in 1993 with the participation of British Columbia's OCIO in the institution's $20 million British Columbia Technology Investment Fund. More recently, OCIO was partnered with OMERS and Ontario Teachers PPB contributions to the 1997 capitalization of the sixth pool established by Ventures West with a mandate for early stage investment, totaling nearly $56 million. As is usual in limited partnerships, these pension funds may also co-invest with Ventures West on specific deals as the portfolio evolves.[47]

From Acorns to Trees

As the Canadian venture capital market matures in the 1990s, it has witnessed some unique and unprecedented initiatives. A good illustration is the increased incidence of specialty or niche venture capital pools. Examples include Genechem, (commercialization of genomics research), MDS Capital Corporation (emerging biotechnology and life science firms), and TechnoCap (emerging information technology firms). These three also happen to have the backing of pension assets.

A second illustration is the recent emergence of seed financing pools. In 1997, Ventures West, in collaboration with the Business Development Bank of Canada and Cascadia Pacific Management, established the $25 million Western Technology Seed Investment Fund, intended to advance promising ideas in universities and other private and public research centres in British Columbia, Alberta, Saskatchewan and Manitoba. Seedings of this kind occur without a formal enterprise or management team in place, but with an innovative product concept recognized as having strong commercial viability.

Along with initial financing that can range from $100,000 to $500,000, the new western Canadian pool will offer value-adding management resources to projects. Among the latter will often be "company creators" or skilled entrepreneurs hired to help construct a business entity around the product concept and potential managers. Company creators assist with market analysis, business plan writing, internal development, personnel recruitment, fund-raising and the formation of customer and strategic partner relationships. Such hands-on support will permit seed projects to gradually become high technology start-ups, creating follow-on investment opportunities in which the pool (and Ventures West) may also invest. Technical experts sitting on the pool's advisory committee provide still further input. After one year in operation, the western seed financing pool made seven investments launching firms from product concepts in assorted research outfits. These include the University of British Columbia, the University of Manitoba and the University of Victoria.

Public sector pension plans associated with British Columbia's OCIO contributed to the capitalization of the western seed financing pool. There is also an eastern counterpart, organized through similar partnerships and geared to provinces in central and Atlantic Canada.

Also in 1997, the Caisse de dépot co-established a pair of Quebec-based seed financing pools. Capitalized at $30 million each by the subsidiary Sofinov, T2C2/Bio and T2C2/Info (i.e., Transfer, Technologies, Commercialization and Capital) also partner with their parent in seedings that lead to start-ups and further growth in emerging biotechnology/life science and information technology industries, respectively. Like the above, financing supports marketable ideas generated in provincial universities and other research centres.

By the end of their first year in operation, T2C2/Bio had initiated several projects in the fields of genomics, drug manufacturing and medical equipment, while T2C2/Info had done the same with regard to new Internet-related technology.

Sources: Western Technology Seed Investment Fund, *Brochures and Press Clippings*, 1997; Znaimer, Sam, *Canadian Venture Capital in the Late '90s — Not Like the Old Days!*, Ventures West, 1998; Caisse de dépot et placement, *1997 Operations Report*, 1998

One of the few private independents to enjoy unbroken pension supply since the 1980s has been Montreal-based Miralta Capital. Unlike most venture capital institutions, it utilizes a corporate structure (as opposed to a limited partnership) to syndicate the assets of institutional investors, a practice that was more prevalent in the 1970s. Incorporated in 1992 and with current assets totaling over $90 million, Miralta is itself the successor to the original Altamira Capital (incorporated in 1984 and possessing assets of over $160 million), and was complemented in 1998 by the approximately $40 million Almasa Capital. The constant over this history has been the management team Altacap Investors.[48]

Like Ventures West, Miralta and Almasa focus on venture financing in high technology industries, including communications, computer products, electronics, industrial automation and specialized manufacturing. Transaction sizes of between $3-5 million are preferred. In general, the portfolios of Miralta, et al, feature a small number of investment projects and significant minority or controlling equity stakes to permit active growth management that yields returns. In each instance, underlying corporate value progresses with the portfolio (and market cycles) and wind-up begins once investee firms have fully matured and either go public or are acquired. Miralta and affiliated corporate entities have over time relied on a group of diverse shareholders, a substantial number of which have been private and public sector pension funds.

The local dimension

By nature, supply and demand in the venture capital market tends to interact within close geographic proximity. As a consequence, such investment activity and any realized economic benefits, such as improvements to the quantity and quality of jobs, are typically local in orientation. This is one of the reasons why venture financing has received heightened interest across Canada as a critical tool for community and regional economic development and diversification.

Historically, Canadian venture capital stock and disbursements have been very centralized. In fact, prior to the mid-1990s, only two in ten institutions resided in sub-markets outside of central Canada.[49] Where pension involvement exists, it has frequently helped to redistribute overall supply trends in the direction of growth-oriented SMEs in the regions. A recent illustration is seen in British Columbia where public sector pension funds have contributed substantially to expansion in the size and range of activity of the provincial venture capital market in recent years. Indeed, committing 37 percent of total new capital, these funds were the top source of supply in 1997.[50]

Of course, the impact of British Columbia pension funds, through the OCIO, on provincial venture investment has its antecedent in Quebec. For many years, Quebec SMEs have captured the largest number of disbursements due to proportionately greater capital resources than most other provinces. Contributing approximately one-quarter of new capital commitments in 1997, the Caisse de dépôt has been key to this outcome. A further step was taken by the Caisse in recent years to distribute venture-backed projects to a broader range of Quebec locales, an initiative that is described in detail under **Pension Assets at the Grassroots**.[51]

The experience of the Caisse in Quebec is similar to that of their public sector counterparts in an increasingly large number of American states. While pension funds in that country have not been shy about entering in the venture capital market, as discussed in **Risk-taking in America**, historic participation has tended to favour the largest state economies with the most sophisticated and best-resourced sub-markets. In 1997, over one in every three such dollars was invested in California, followed by Massachusetts and Texas.[52] California's overwhelming share is only partially due to the efforts of CalPERS to locate at least half of its allocations to alternative/non-traditional assets, including venture and non-venture equity to its home state.

According to a 1995 research report prepared for the federal Small Business Administration, the advent of pension-sponsored economically-targeted investments (ETIs) (see **What's an ETI?**) or equivalent programs where attributable economic effects are real, but more incidental, have helped to alter this large state bias. Results of a survey showed that individual programs had facilitated venture investment in SMEs in twenty-one out of twenty-nine states.

Cited for unusal efficacy were the ETIs of Colorado led by the sixth largest pension supplier in the United States, the Public Employees' Retirement Association (PERA) of Colorado. In combination with two other state-based pension funds (each of which have committed 3 percent of assets to this class), PERA has been credited for leveraging an inordinately large per capita share of venture capital supply to this mid-sized state economy. Potent ETI models were also found in New York, Pennsylvania and Wisconsin. Moreover, the Small Business Administration report concluded that the impact of ETIs and other initiatives for strategically re-allocating assets was greatest in small and disadvantaged state economies where public sector pension funds proved a driving force.[53]

Pension Assets at the Grassroots

Along with achieving benchmark financial returns, the raison d'etre of the Caisse de dépôt et placement has been to invest with reference to Quebec economic needs. If allocation of assets is the measure, this mandate has been amply fulfilled — in 1997 over 80 percent of Caisse investing was situated in Quebec. In recent years, this effort has been broadened to include local economic development, the primary instrument of which is the Accés Capital network of regional pools.

Actually, this initiative was preceded by earlier Caisse de dépôt experience in the Sociétés régionales d'investissement in syndication with three other financial institutions and with government support. Originally intended as a network of about a half dozen regional pools, Accés Capital was founded in 1996 as an independent arm of the Caisse Private Investments Group and, today, comprises eleven pools capitalized at a total of $100 million.

With respect to investment, the network has multiple roles. First, Accés Capital pools receive local business plans, conduct due diligence and offer direct SME financing within a deal range of $50,000 to $750,000. Much of this transacting is carried out using term loans, a function the Caisse de dépôt has undertaken due to its increasing capacity for directing in-house credit analysis, account management and risk control. In the main, borrowers are well-established SMEs with roots in the traditional manufacturing and service industries of regional economies. Venture financing is also extended (often, in combination with debt), especially where new business formations with growth prospects have emerged from sponsoring incubators and other SME development programs (see **Caisse de dépot: Ways and Means**). In larger projects (up to $1 million), regional pools co-invest with Capital CDPQ. Accés Capital also acts as a link between SMEs in Quebec communities and the full line of products and services made available by the Caisse.

Given its short history, characterized by organizational start-up and initial investing, most of Accés Capital's story has yet to be told. This said, at the end of 1997 investments totalled seventeen at an aggregate portfolio value of $13 million. Pools are currently found in twelve regions: Abitibi-Témiscaminque, Bas-St.Laurent, Centre du Québec, Estrie, Gaspésie-Les-Iles, Laval-Laurentides-Lanaudiére, Montérégie, Montréal, Outaouais-Hull, Québec, Québec-Beauce-Appalaches and Saguenay-Lac St-Jean. Additions to the network and network resources will be contemplated over time.

The Caisse approach has been emulated elsewhere, as seen in the strategy of the New Brunswick Investment Management Corporation (IMC) to apportion 2 percent of total public sector pension assets, or over $100 million, to privately-placed debt and equity. This money goes to backing high-yield co-investment and syndication projects that may incidentally contribute to economic development, diversification and job creation in communities across the province. Various investment targets include local SMEs in traditional industries and infrastructure. A current project involves up-grading of the highway system in the Fredericton to Moncton corridor. The newly-incepted strategy of the New Brunswick IMC suggests a potential model for pension participation located elsewhere in Atlantic Canada.

Sources: Caisse de dépot, *Brochures* and *1997 Operations Report*, 1998; CLMPC interviews

Some concluding thoughts

The importance attached to the health of the institutional venture capital market in Canada has grown with appreciation of the need to replace declining, traditional sources of economic output and jobs with new ones, and particularly as regards knowledge-based production. If new and developing SMEs are to contribute to this end, long-term venture capital supply and investing must be constant and evenly distributed to provincial/regional sub-markets to assist local economic development and diversification. Because this has happened to a greater degree in the 1990s, the market has shown signs of maturation on both its demand and supply sides.

However, due to awkward shifts in supply conditions over the past two decades — including the departure of pension funds and other institutional investors, following the challenges of venture financing in the 1980s — the federal and provincial governments have retained a role in ensuring adequate resourcing. This is not unlike how venture capital markets have evolved elsewhere, such as the United States and Australia (see **The Pension Difference Down-under**), though eventually, government financial leveraging has yielded somewhat to more durable private supply sources.

While in the two aforementioned countries, pension funds have emerged as top backers of venture investment activity, in Canada they occupy a minor position, at least outside of Quebec. One unfortunate result remains less balanced supply sources in this country. The end of 1997 may well represent a turning point, however, given the influx of capital commitments from large funds — some new to the market, some not — as illustrated above. All seem to be taking cautious, strategic steps. If this indicates some selectivity concerning co-investment partners or pooling vehicles, as pension managers have told the CLMPC, this may turn out well in the long-term.[54]

At the same time, such pension funds are already partners to several innovations, such as seeding projects and support for spin-offs of successful Canadian high technology firms (that are new even in the venture capital market). This signals that pension participation of the 1990s may be more full-spectrum (i.e., seedings, start-ups and early stage developments in addition to expansions and later stage developments) than it has been previously.

Precedents also suggest that the experience such large pension funds are gaining in non-venture equity (i.e., over the $7-10 million mark) and merchant banking (see **Pension Funds and Middle Market Investing**) can lead to more enhanced exposure to venture equity (i.e., under $7-10 million mark) down the road. Because of their long-term focus, they will increasingly be able to influence trends in the latter to suit pension needs — for instance, in relation to limited partnerships and other syndications that remain the market's chief conduit.

At the same time, it should be acknowledged that the large pension funds providing the impetus behind heightened participation in the Canadian venture capital market in 1997 are few in number, large and almost exclusively from the public sector. Many are also first-time entrants. This suggests something of the serious dissatisfaction that remains with fiduciaries whose private or public sector (of all sizes) completely withdrew from the market following their 1980s experience. This situation is unlikely to change in the immediate future unless certain barriers, such as those raised by the 1998 CLMPC-PIAC survey, are addressed with deliberation. This topic is explored in **Pension Barriers to Financing New Economy Investment**.

5. Pension Funds and Middle Market Investing

What is the middle market?

There is no precise definition of the middle market that enjoys broad subscription in the Canadian financial system. Indeed, the realm of private debt and equity placements that can be roughly ascribed to the phrase "middle market investing" is certainly among the least discussed, examined and comprehended of all capital markets. This is unfortunate since an increasingly large volume of capital resources has recently been pouring into Canada's middle market, at the behest of several new financial institutions, investors and agents specialized in its often complex, high yield transactions. Moreover, middle market investing has assumed a critical role in the national economy.

The middle market is perhaps best discerned in the character of its essential demand targets and supply sources. The demand side of the market is primarily composed of medium-sized and larger enterprises. Compared with other SMEs, such firms are distinguished by greater maturity (e.g., anywhere from ten years to several decades old), an established business status (e.g., long track records, experienced managers), and an established financial status (e.g., some collateral, consistent streams of revenue). As a consequence, they tend to enjoy access to a broader spectrum of external financing options.

For the most part, middle market financing demand is also to be found in traditional manufacturing and service industries. The majority of business clients are also private and closely-held; as a matter of fact, many are family-owned. Another client group is larger corporations that are publicly-listed and traded.

The middle market is sometimes discussed with reference to the identity of its supply side. These are, in the main, investment or merchant bankers. While the latter term also suffers from imprecise usage, merchant banking generally refers to the private placement activity of the divisions, subsidiaries and pooling vehicles of large corporations, lenders and institutional investors, such as employer-sponsored pension funds. As a financial institution, its genesis has been traced to the establishment of Hees International in the 1970s. [55]

Middle market "events"

Despite having certain advantages over other SMEs, firms active in the middle market still encounter significant financing impediments. Apart from the standard explanations linked to size, information problems, etc., this is due to the unique and multi-various development needs and patterns of well-established, traditional, medium-sized business, especially in the current economic context.

For this reason, middle market investing has been dubbed "event-driven." This means that events or happenings of a very specific nature in firms, or in relation to firms, in certain industries or sub-industries, determine the financial transaction to take place as well as the potential range of supply solutions.

For instance, in attempting to expand productive capacity, a private middle market client may proceed, much like a late stage venture-backed project, towards initial public offering. Alternatively, the same end may be facilitated by a business combination event, such as a merger or acquisition, which leaves the final entity in private hands. Restructuring, manifest in examples of major internal re-organizations, financial distress or management of substantial cost liabilities, is also a pervasive influence in middle market deal-making, as is changing ownership, sometimes assisted by leveraged buy-outs. Publicly-listed firms may also seek out merchant banks if their investment requirements cannot be easily or cost-effectively financed in securities exchanges. These are all "events."

A detailed list of typical projects that regularly receive disbursements in the middle market is provided in **The Event-driven Middle Market**. A consistent theme in most examples is business preference for private placement over financing through public securities exchanges.[56]

The absence of data concerning the exact nature, scope and dimensions of Canada's middle market make it impossible to expound at length on its contemporary development or pension participation. What information the CLMPC was able to obtain from interviews and written material comprise the balance of this section.

The middle market's economic role

Important economic trends are reflected in growing attention paid to the middle market. Among the most obvious, of course, are structural shifts taking place within traditional industries, and particularly manufacturing and retail industries, that have prompted consolidation, modernization and transition to "niche" production, often geared to export markets. Most middle market events are rooted in responses to new competitive pressures brought on by globalization, altered trading relationships, and other fundamental economic challenges.

The Event-driven Middle Market

If established medium-sized and larger business comprise the client base of the middle market, what reasons might compel such to approach merchant banks and other suppliers of privately-placed debt and equity, including those backed by pension assets? The following is a list of typical company-based "events" that frequently drive demand. These examples have been derived from CLMPC interviews with pension managers, market analysts and practitioners and from research sources in Canada and the United States.

- ✓ Private, closely-held firms aiming to expand or undertake significant new investment, but do not wish to go public
- ✓ Mature private enterprises aiming to make a public offering for the first time
- ✓ Growth-oriented firms with a particular interest in becoming dominant or major industry-specific players
- ✓ Enterprises seeking to acquire or merge with other Canadian business entities
- ✓ Enterprises seeking to acquire or merge with other cross-border business entities
- ✓ Firms seeking to effect change in ownership to new management or within an existing family-owned arrangement (e.g., succession plans)
- ✓ Firms in which majority ownership is transferred through manager or worker buyouts
- ✓ Enterprises aiming to refinance or significantly alter internal capital structures (e.g., debt-to-equity balance)
- ✓ Traditional industry firms (e.g., manufacturing) engaged in extensive restructuring
- ✓ Enterprises encountering a financial distress situation that require rescue or turnaround assistance
- ✓ Large firm divestiture of product divisions to independent business entities under new or existing management teams
- ✓ Publicly-listed firms with especially complex or high risk transactions (e.g., leveraged buyouts, mergers and acquisitions) that cannot be satisfied in exchanges
- ✓ Publicly-listed firms aiming to finance investment that avoids costs associated with exchanges
- ✓ Publicly-listed "orphans" that entered exchanges too early, but retain commercial viability from a private perspective

Source: CLMPC, 1998

There is concern about the responsiveness of traditional medium-sized firms to such challenges, which may be undermined by under-investment in the middle market. Canadian merchant banker Gordon Sharwood (Sharwood and Company) has repeatedly noted that insufficient debt and equity pools probably inhibit the health and progress of this country's medium-sized business sector in a changed domestic and global environment. If the sector is to grow as it has in other national economies, he argues, middle market investing must be addressed as emphatically as the needs of large corporations and new business formations.[57]

Unions in Canada and internationally are concerned about the negative impact on-going rationalization and restructuring trends can have on existing, well-paying employment found in traditional workplace settings. In fact, this has led some in labour to express an interest in the potential of merchant banking to protect and preserve jobs through rescue operations for firms temporarily caught in short-term cyclical downturns and low levels of profitability. In the United States, the Economic Policy Institute (EPI) has confirmed the necessity of such investment activity to union members given precipitous erosion in the base of high-wage jobs provided by large manufacturers over nearly three decades. Compounding this dilemma is the trouble small manufacturers currently encounter in attracting financing to sustain a growing presence in this sector.[58] The EPI's warning about the future of many firms in competitive and job-intensive American manufacturing industries without adequate capital for investment is applicable to Canada and, above all, to Canadian single industry communities and regions of low economic diversification.

Preventing firm closures where there remains commercial viability or encouraging new development, sometimes through buyouts by employees (or through other worker financial participation schemes) or by managers, is another important function of the middle market. In Canada, this process has been underway for some time in such industries as forest products and steel, though demand does not always met with capital supply.

Succession of company ownership is still another economic change issue resolved in the middle market. Increasingly, it has become necessary for large numbers of private, family-owned firms begun in the postwar years to transfer ownership from aging founders to a next generation of heirs (i.e., family members or new managers). This procedure often entails a succession plan and financing from a merchant bank. SME succession planning that maintains resident ownership is a paramount concern in individual communities and regions, especially in rural Canada.

The middle market does not always witness outcomes of clear-cut economic benefit. Public controversy occasionally arises over the volume of capital resources expended on corporate concentration and particularly leveraged buyouts. Proponents argue that, at its best, this activity can help maximize economic efficiency and productivity — by integrating multiple business entities, for example. On the other hand, detractors argue that such investing results in little more than "paper entrepreneurship" and, at its worst, can actually be jobdestroying. Much depends, of course, on the project in question.

Regardless, leveraged buyouts have been gathering steam, evident in the United States where pools managed by specialists in this field, such as Kohlberg, Kravis and Roberts, have attracted more than $70 billion in the past two years from pension funds and other institutional investors. This has transpired despite concern about the price impact of huge cash infusions and about waste given a finite number of quality buyout situations.[59] At present, Canada has no leveraged buyout market of comparable size and scale.

Financing options in the middle market

The financial means of the middle market are no less heterogeneous than the events they try to address. This said, it is not uncommon for the owners of medium-sized and larger firms to be unaware of the existence of private placement alternatives to going public or otherwise relinquishing some portion of ownership. One task of merchant banks, and other middle market advisers and intermediaries, is to apprise prospective business clients of these financing options.

A second task is to design an investment strategy that deals with specific event-driven circumstances and goals. Some events may be satisfied by patient debt that improves on the terms of most conventional, collateralized loans. In other situations, what may be necessary is a multi-layer deal structure, reflecting a mix of financial instruments to effect the intended result. Depending on a project's risk orientation, impetus may be provided in a layer or layers of equity or quasi-equity. This often introduces what is referred to, in practitioner parlance, as the "kicker." Finally, some middle market investing may be handled with equity alone. All financing solutions must account for inherent strengths and weaknesses (e.g., debt load) of the existing internal capital structures of medium-sized and larger clients.

Naturally, strategic responses as singular as the event imply diversity in debt and equity combinations, time frames, and methods of oversight or, where necessary, more active, value-adding management. Diffuse events also spawn financial specialization. Some merchant banks may observe a general mandate for financing all "core" middle market events. Others may direct their whole attention to certain investment activity, as Schroders & Associates Canada does in relation to leveraged buyouts.

Again, depending on a transaction's inspiration as an event, the relative size of financing will vary in the Canadian middle market. Market analysts and practitioners indicate that, on average, deal size parameters are in the order of $5-50 million. Though comparatively rare, amounts invested can also be well in excess of $100 million.[60]

What follows is an overview of the debt and equity tools of middle market event transactions: operating and term loans, mezzanine financing and non-venture equity.

(1) Debt financing

The credit requirements of the majority of Canadian SMEs are quite modest, necessitating loans that are mostly short-term and involve sums of $50,000 or less. Middle market borrowing demand is of a different magnitude.

For instance, credit needs of medium-sized enterprises in the market can entail illiquid investing (e.g., up to five years or more). Hence, their objectives may be best facilitated by intermediate or long-term loans at fixed rates. These are often packaged in customized contracts sufficiently flexible to anticipate changes in the creditor's economic status over time. Such loans may also be only partially collateralized or unsecured. The trade-off for such terms and conditions are, of course, interest of above average rates.

The extent of this low visibility term lending is not fully documented in Canada. In the United States, the Federal Reserve System has shown private debt placements in the middle market (beginning at around $10 million) to rival, in volume of issues, both bank lending and the public corporate bond market. (see **In Debt to Pension Funds**).[61]

Pre-eminent among lenders to the Canadian middle market are life insurance companies that offer, among other financing, long-term corporate debentures (unsecured debt) implemented using sophisticated risk control technologies. This function is well suited to them since, like pension funds, assets and liabilities must be balanced over long periods.

A potent debt-like instrument in the middle market is mezzanine financing. Also known as subordinated debt, such financing occupies a halfway point between debt and equity, strictly defined. It is called "subordinate" because it acts as one layer within an investee firm's multi-layer capital structure that comes after senior debt (i.e., term loans), but ahead of common equity. Its equity aspect frequently appears as the aforementioned "kicker" whereby the instrument is converted to, or otherwise shares in, the investee firm's ownership or earnings. In general, subordinated debt is linked to cash flow projections, is of longer duration (e.g., 5-10 years) than senior debt, and earns higher risk-adjusted returns.

In Debt to Pension Funds

Historically, SME debt financing has almost no representation in the fixed income allocations of pension funds. There is a reason. Most of it consists of very modest, short-term loans that may suit the deposit-taking financial institution, but not necessarily the more cautious and cost-sensitive institutional investor.

Some American market analysts have argued that pension funds possess a natural affinity for private debt placements beginning at around $10 million (US $) and involving medium-sized borrowers. Recently, the Federal Reserve System estimated the volume of such debt issues to be about two-thirds of that in the public corporate bond market and such debt outstanding to stand at more than half of total bank loans. While life insurance companies have been responsible for over 80 percent of this activity in the past, their supply role has diminished, precipitating a "credit crunch" in the American middle market in the early 1990s. The Federal Reserve noted that pension funds were in the best position to fill the gap.

A few state-based pension funds, such as the $54 billion (US$) State of Wisconsin Investment Board (SWIB), have done so. In 1998, SWIB led all other American pension funds in asset allocations to private debt placements, followed closely by Retirement Systems of Alabama. One aspect of SWIB's program is a $300 million direct lending mechanism developed over several decades through an in-house account management unit of skilled credit analysis and monitoring personnel. SWIB generally makes fixed-rate, intermediate and long-term loans to established, medium-sized firms in manufacturing, retail and service industries in the state. Loan sizes average $10 million, but may be as low as $3 million. The balance of SWIB's nearly $3 billion in debt financing is conducted through various other means, including sale-and-leaseback arrangements, asset-based financing and non-residential mortgages.

SWIB puts an additional $300 million into 130 Wisconsin banks and thrifts through purchases of certificates of deposit (CDs). Under this model, lending institutions can acquire from the pension fund a maximum of $10 million for periods of months and up to three years. By way of these fully-insured CDs, SWIB indirectly capitalizes loans that will, in some instances, be extended to local small business, while leaving management-intensive creditor tasks to specialists. CD purchases are practiced by pension funds in some other states, such as Pennsylvania, in some cases with the qualification that lender criteria be explicitly linked to SME borrowers.

Subordinated debt is one of the primary financial instruments deployed by the $127 million (US $) Texas Growth Fund (TGF), capitalized in two pools by three public sector pension plans, including the Teacher Retirement System of Texas. With a preference for co-investment situations, the TGF targets state-based, medium-sized enterprises in deals ranging from $2-6 million in size. The mid-1998 portfolio, valued at $67 million, is comprised of thirty investee firms, mostly situated in traditional manufacturing industries. TGF got its start in 1988 with statutory endorsement by the Texas government.

Sources: US Federal Reserve System, *The Economics of the Private Placement Market*, 1993; Texas Growth Fund, *Brochures*, 1998; SWIB, *Brochures*, 1998; CLMPC interviews

Mezzanine financing is vital for many reasons. Sometimes, it serves as the step following a growth-oriented firm's venture phase and expedites, or substitutes for, public offering. As debt, it may appeal to middle market clients preferring not to dilute existing ownership. It is based on contracts and covenants similar to those of term loans, but that are more flexibly customized to borrower specifications. Subordinated debt can be an adjunct to a financing solution or operate in purer form. As the latter, it is an adaptable and cost-effective alternative to equity.

Market analyst and practitioner Kevin McKenna (McKenna Gale Capital – see below) has written extensively on the character and history of mezzanine financing, emphasizing its evolving performance in assorted event transactions, including expansions, mergers and acquisitions. This evolution has not been challenge-free, however. A series of regulatory reforms in the 1980s, combined with effects of the recession at the end of that decade, notes McKenna, placed severe restrictions on the commercial lending practices of banks. One result was a reduction in what had been significant bank supply of subordinated (and senior) debt over the course of the 1990s.[62]

Today, middle market clients must turn to specialized mezzanine pools (see below), merchant banks or pension funds and other institutional investors to pursue this option. This said, it is likely that total supply of pure subordinated debt is inadequate relative to demand in Canada, as compared to the United States (see Figure 9). Market practitioners interviewed by the CLMPC believe this reflects a major capital gap of relevance to SMEs.[63]

(2) Equity financing

One of the most important middle market developments of the 1990s is the new liquidity gained by an increasing influx of non-venture equity. Indeed, along with mezzanine financing, equity is establishing a much higher profile and utility in all event transactions, particularly those that reflect large sums, illiquidity and above average risk.[64] This trend parallels that of American private capital markets over the past two decades.

As was discussed in **Pension Funds and Venture Investing**, while the investment activity of venture and non-venture forms of private equity overlaps, to some extent, their respective markets are fairly distinct. Once invested, the two perform similarly, though according to very different client needs. Recently, Macdonald & Associates has begun collecting data on non-venture disbursements, defined as above $7 million, made by a growing array of merchant banking and private placement arms of corporate and financial sponsors, including pension funds.

Capturing a substantial fraction of the 1997 non-venture equity universe, Macdonald & Associates reported fifty-four deals done at a total value of $2.5 billion.[65] This private placement activity, rooted in either equity or subordinated debt, featured deal sizes in the range of $7.5-250 million, much of which was syndicated by the merchant bank subsidiaries of banks and pension funds (e.g., Ontario Teachers PPB) and limited partnerships of the type discussed below. Investee firms, such as Anchor Lamina (Windsor, Ontario), Groupe Benoit Allard (Chicoutimi, Quebec), Tree Island Industries (Vancouver, British Columbia) and ZCL Composites (Edmonton, Alberta) are situated primarily in manufacturing and service industries.[66]

Pension funds and the middle market

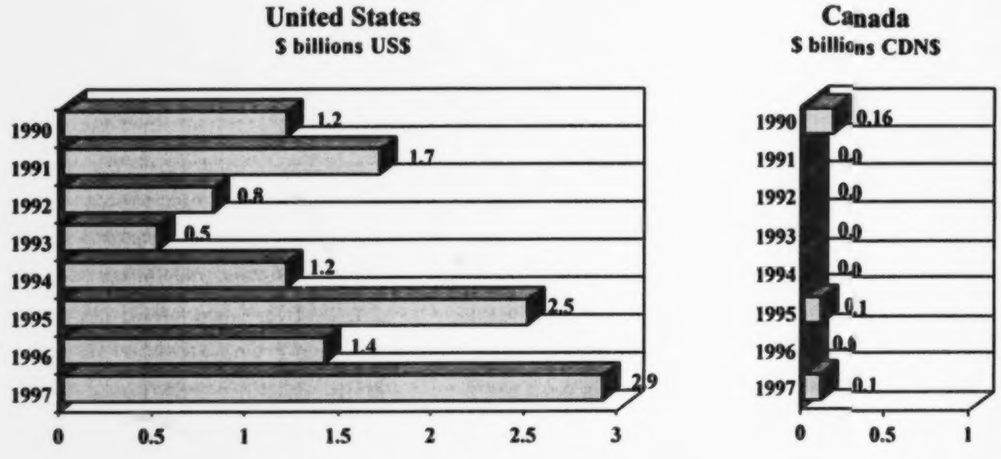
Canadian merchant banking was in a fledgling state in the 1980s and somewhat undifferentiated from other private capital markets, such as venture capital. All indications are that, beginning in the early 1990s, the middle market has gained considerable breadth and depth. Integral to its current supply, pension funds have also been influential in this structural development. Today, some of the biggest merchant banking operations are those of the Caisse de dépôt, OMERS and Ontario Teachers PPB, while HOOPP and the public sector pension plans associated with Alberta Treasury's IMD and British Columbia's OCIO are top suppliers to pools.

As private capital markets go, middle market investing is fairly conducive to pension asset exposure. Event-driven transactions draw on the pension fund's quality for patience. At the same time, risk-adjusted returns are possible at relatively low cost, achieved through a few deals of substantial dollar value and featuring traditional, demonstrably profitable business. Of course, these same factors may incline some pension funds to invest in the market's upper end and even larger private placements (e.g., above $50 million).[67]

Using data supplied by individual pension funds and Macdonald & Associates, the CLMPC estimates pension supply to private debt and equity investments in the Canadian middle market to have approximated $4-5 billion, at a minimum, in 1998 (or roughly 1.0 percent of total pension assets). Without knowledge of the current size of the market universe, it is not possible to say what proportion of total supply this represents. What is clear from CLMPC interviews with pension managers is that the share of total capital under management originating with large public sector funds has been on the rise since early in the present decade.[68]

Pension funds can participate in the middle market either directly, by co-investment with other merchant banks, et al — often on an individual project basis — and indirectly. Generally speaking, the indirect approach entails syndication of pension assets in an externally-managed pooling vehicle, such as a limited partnership.

Figure 9
Estimated Supply of Capital Raised for Mezzanine Pools, Canada-U.S. Comparison, 1990-1997



Source : Macdonald & Associates and *Private Equity Analyst*, 1998, with CLMPC thanks to CCFL.

Due to its size, there are, in proportional terms, fewer limited partnerships and other pools in the Canadian market as compared to the United States (see **Of Pools and Pooling**. At present, costs and risks can be practically shared among a small group of merchant banks (both domestic and international), such as CIBC Wood Gundy Capital, Royal Bank Equity Partners and TD Capital Group and advisers/agents, along with the management-intensive tasks of finding, selecting, structuring and monitoring deals. This said, those pools that do exist (see below) are central to on-going investment activity. Room for this model may also grow in the years ahead, parallel to heightened demand and supply in the Canadian middle market.

A selection of direct and indirect systems in Canada is illustrated here.

(1) Direct pension participation

With significant stakes in Canadian middle market investing, OMERS and Ontario Teachers PPB are illustrative of direct pension participation. The former was one of a handful of pension funds engaged extensively in merchant bank-like activity in the 1980s when leveraged buyouts were of prevailing interest to large institutional investors.

Inception of the Merchant Banking and Private Placement program at OMERS occurred in 1981, but it was not until the 1990s that it became fully administered on an in-house basis. Over the years, new investments have averaged 10-15 per year. Today, the OMERS portfolio is broadly representative of core event-driven transactions in the middle market with individual investments sized at between $10-50 million or above. Over the years, new additions to the portfolio have averaged 10-15 per year. While market agents and co-investors suggest potential deals, OMERS also encourages a direct flow through advertising of its program's mandate.

The Merchant Banking and Private Placement program at OMERS utilizes a range of financial instruments, the most prominent being approximately $600 million in non-venture equity. Around $200 million is also apportioned to intermediate and long-term loans, available for financing medium-sized or larger enterprises independently or in strategic combination with equity in layered deal structures. Where necessary, subordinated debt may also play a role. In mid-1998, the portfolio value of the OMERS program was close to 2.7 percent of total plan assets, a level that may be raised to 5 percent, future circumstances permitting.

The approximately seventy investment projects that currently receive OMERS debt and equity placements suggest the middle market's traditional industrial mix, plus some business of specific interest, such as oil and gas and established high technology. 60 percent of all investing, direct and through partnerships, is in Canada. Along with their merchant banking operations, eight internal managers handle OMERS infrastructure projects as well as venture capital commitments to external limited partnerships (see **Pension Funds and Venture Investing**).[69]

The in-house Merchant Banking Group of Ontario Teachers PPB has functioned chiefly as a private equity investor since 1991, though in 1998, it added mezzanine financing to the mandate. Evolving rapidly over its very short history, this program has participated in over eighty investment projects averaging about $20 million in size. The bulk of these have been leveraged management buyouts. One illustration is the acquisition of the Ontario metal and plastics manufacturer ATS in by 1992, by management's purchase of majority interest from the non-resident parent. This was followed a year later by public offering.

Generally speaking, Ontario Teachers PPB is interested in medium-sized and larger business clients seeking a private placement alternative to going public. Like most large institutional investors, it prefers investment deal sizes of $50 million and above, however, the relative scarcity of these has led to increasing concentration on those in the middle market of less than $25 million. Deal flow comes directly to the Merchant Banking Group, from market agents and intermediaries and from regular co-investment partners.

At the end of 1997, the total investment portfolio was valued at $1.7 billion or approximately 3 percent of total plan assets. Asset allocations have risen steadily over the years and, like OMERS, may yet reach 5percent exposure, subject to long-term market developments. Two-thirds of investee firms are Canadian, the majority of which are found in Ontario, and situated in a variety of traditional industries, though some are established technology-intensive companies. A twelve-strong management team at Ontario Teachers PPB also administers venture capital commitments to external partnerships and pools (see **Pension Funds and Venture Investing**).[70]

(2) Indirect pension participation

As its name implies, Penfund Management originated by syndicating the assets of pension funds, beginning in 1976, with a mandate for middle market investing. Since the late 1970s, it has invested close to $2 billion. This has been accomplished by collaborations with dozens of plans (and other institutional investors), through Penfund Capital (No. 1) — the pension-owned pool that capitalizes all portfolio projects — and through leveraged co-investments, generally on deals exceeding $5 million.

Penfund works predominantly with borrowers, usually with commercial goals of expansion, acquisition or recapitalization, and structures deals with intermediate and long-term loans that are sometimes mixed with equity or quasi-equity to address certain inherent risks and yield expectations. In general, debt financings (senior and subordinated) are between $1-15 million. Penfund's current portfolio stands at between 100-120 projects and a total value of around $700 million. For the most part, investee firms are medium-sized manufacturers and processors located throughout western Canadian provinces, Ontario and Quebec.

Today, Penfund's suppliers include British Columbia's OCIO, General Electric Pension Plan, HOOPP, Manitoba Teachers Retirement Board, Maple Leaf Foods Pension Plan and Ontario Hydro Pension Plan. Major decisions concerning policy and the undertaking of new loans of above $5 million are the purview of this body. [71]

In its early life, beginning in 1979, the mandate of Canadian Corporate Funding Limited (CCFL) was venture and non-venture equity financing through pools that relied partially on pension funds. Since the late 1980s, CCFL has shifted to a middle market concentration. One of its functions is as an agent for medium-sized firms seeking long-term loans from institutional investors. Another is direct supply of pure subordinated debt. CCFL-expedited projects feature domestic and cross-border mergers and acquisitions, divestitures, expansions, leveraged buyouts and emerging or established firms that can or do act as leaders in specific industries.

CCFL created the first Canadian limited partnership specializing in dedicated mezzanine financing in 1989. The $155 million CCFL Subordinated Debt Fund I was capitalized by eighteen institutional investors that included the pension plans of Chrysler Canada, the University of Quebec and Cominco. This was followed, in 1997, by the $106 million CCFL Subordinated Debt Fund II. CCFL's current mezzanine group of five full-time professionals manage these pools and invest at the lower end of the middle market or deal sizes from $7.5 million to $50 million — demand that is frequently overlooked by merchant banks interested in larger projects (e.g., $50-100 million and over).[72]

Since inception, CCFL has leveraged approximately $900 million in private debt placements in the middle market, of which close to one-third has been mezzanine-related. Though headquartered in Toronto, Ontario, CCFL operations are extended nationwide.

Another major syndicator of pension assets in this market is McKenna Gale Capital (Toronto, Ontario). This is a specialty manager of mezzanine and non-venture equity capital pools directed towards a wide assortment of middle market event transactions, particularly expansions, mergers and acquisitions, across the country. Although senior debt financing is not central to its mandate, McKenna Gale also possesses the capability to provide it, where necessary. Investment projects vary in size and encompass those below $50 million thereby reaching medium-sized business that might otherwise experience under-investment.

In 1996, McKenna Gale undertook its first limited partnership — the $100 million MG Stratum Fund I — facilitated by several institutional investors, including the public sector pension funds of British Columbia's OCIO and HOOPP. By the end of 1997, MG Stratum I had invested $84 million in seven medium-sized enterprises. The success of the first pool has led to commencement of a second, MG Stratum Fund II, to be capitalized to a level of $200 million.[73]

The local dimension

Unlike venture financing which operates, in the main, close-to-home, a certain amount of international exposure can be one of the appeals of pension-backed merchant banking and other private placement activity. Several large Canadian pension funds seek the superior financial return opportunities presented in private capital markets abroad and, in particular, those situated in the United States and countries in Europe and southeast Asia.

In some instances, the relationships established through global co-investment, partnerships and networks act to support the outward expansion of Canadian business. While large corporations provide much of the impetus behind cross-border economic activity, growing, export-oriented SMEs are also increasingly important contributors — in 1997, the Organization for Economic Development and Co-operation estimated that one-quarter to one-third of world exports in manufactured goods originated with the latter.[74] Pension funds with stakes in both Canadian and global private equity investing are in an especially good position to assist small entrepreneurs pursuing internationalization. For some, such as the Caisse de dépôt, this is an explicit strategy on behalf of new and developing Quebec SMEs (see **Caisse de dépôt: Ways and Means**).

This said, most pension asset allocations to privately-placed debt and equity are currently extended to medium-sized and larger enterprises in national and provincial middle markets. This is evident in both the externally-managed pools and internally-managed programs outlined above, regardless of the event transactions preferred in each case. Moreover, CLMPC interviews with limited partnership managers found that pension funds, especially those in the public sector, often make distribution of middle market investment opportunities to their resident province or region a contingency of participation. This is currently true for both Penfund and McKenna Gale Capital.

Further illustrations exist in sub-markets in British Columbia, Quebec and New Brunswick. On Canada's west coast, a 1993 program called BC Focus, intended to leverage matching levels of government and private sector capital resources for SME financing, encouraged a contribution from pension funds. An original goal was a more vital and better-supplied provincial merchant banking sector. Among the institutions supported by public sector pension plans associated with British Columbia's OCIO under this initiative is the British Columbia Mercantile Corporation. This merchant bank, active since 1989, invests directly or arranges for co-investments in middle market projects, including acquisitions, divestitures, expansions, management buyouts, restructurings and turnarounds.[75]

In Quebec, the Caisse de dépôt's Capital d'Amerique CDPQ concentrates almost exclusively on deals involving medium-sized and larger firms situated in traditional manufacturing, energy, resource extraction and service industries. At the end of 1997, the subsidiary's portfolio comprised 183 investments at a total value of $2.6 billion.[76] A similar disbursement of private debt and equity has been undertaken by New Brunswick public sector pension funds, under the auspices of the newly-constituted New Brunswick IMC, as briefly described in **Pension Assets at the Grassroots**.

In the United States, several economically-targeted investment (ETI) programs, or ETI-like programs, exist with middle sub-market mandates, often with pension sponsorship. One example is the Private Capital Fund (PCF) of the Union Labor Life Insurance Company (ULLICO), established in 1995 to extend loans, equity or mezzanine financing within a range of $2-5 million and in mature companies seeking to grow internally or through acquisitions. If feasible, investment projects of ULLICO's $100 million pool are also chosen where there is a clear prospect for benefiting unionized employers, the jobs of union members and the communities in which they reside. The assets of Taft-Hartley (jointly-trusteed, multi-employer) pension funds supply this mandate.[77]

Some concluding thoughts

In Canada's financial system, middle market investing occupies increasingly crucial ground between SME term lending and venture financing, on one side, and public securities exchanges, on the other. Though its parameters are a little fuzzy, the market's primary clients, and the economic events that drive investment in them, are recognizable and of no small importance. Private firms seeking to develop without diluting ownership by going public. Publicly-listed firms needing to revert to private placement. Family firms aiming to transfer ownership to a next generation. Firms in traditional industries that require restructuring or rescue. Mergers and acquisitions among firms adjusting to a global economy. A great many are medium-sized. These are the targets of middle market investing, the output and job-related outcomes of which are both economy-wide and specific to communities and regions.

Caisse de dépot: Ways and Means

Experience tells. Consider, for instance, the over thirty years of history behind the Caisse de dépôt et placement since its 1964 inception in the Quebec National Assembly with a raison d'etre to invest public sector pension assets in a fashion that would maximize financial earnings and attain a positive economic impact.

Today, it is estimated that around $3-4 billion is conveyed to Quebec business growth through the matrix of in-house subsidiaries of the Caisse Private Investment Group (see **Pension Funds and Venture Investing**), the bulk of which reaches new and developing SMEs. Impressively, the Caisse approaches this task with a finely-tuned, comprehensive and long-term strategy for deploying capital, actively-managing projects and providing value-adding programs and specialized professional expertise.

To start, Caisse subsidiaries are positioned at all points of the financing continuum, with roots in multiple capital markets, including SME term lending, venture financing, other private placements and small-cap public equity. As such, they are able to respond with craft and flexibility to business plans articulating diverse SME propensities and goals, including multi-stage growth and expansion into both domestic and export markets. Much of the related Caisse deal flow is handled by Capital CDPQ and Capital d'Amerique CDPQ, while a more specialized focus is applied to SMEs in emerging knowledge-based and technology-intensive industries by Capital Communications CDPQ and Sofinov. Other subsidiaries also engage in industry-specific investing, such as Sodémex (junior mining and exploration companies) and Services financiers CDPQ, (developing financial institutions, including mutual funds). To expedite SME progress in the global economy, Capital International CDPQ fosters co-investments, business and financial networks and strategic alliances abroad.

The Caisse often utilizes extensive research to target industries that anticipate Quebec economic development or to fill specific gaps identified in SME access to capital. Academics, industry analysts and scientists also serve in formal capacities to assist in continuous financial innovation and specialization. This emphasis on "smart" capital has led to new methods of ameliorating SME growth. For instance, the Caisse promotes more sophisticated Quebec entrepreneurship by use of eleven independent commercial development centres or incubators. Such entities, such as Montreal-based Inno-Centre Québec, render start-ups and early stage SMEs "investment ready", frequently by passing them through an intensive incubation process that gives them access to business mentors, development services, technical advice and training.

Several leading Quebec enterprises were born through Caisse sponsorship. One is Telesystem International Wireless, the export-oriented cellular telecommunications firm that originated in the rural region of Saguenay-Lac St-Jean and made the climb from start-up to blue chip. The advent of Accés Capital (see **Pension Assets at the Grassroots**,) suggests more Caisse finds are possible in communities across Quebec down the road.

Sources: Caisse de dépot, *Brochures* and *1997 Operations Report*, 1998; CLMPC interviews

Though smaller and less developed, Canada's middle market appears to be moving along the same path as that in the United States. Because it is small, investment patterns are set by a modest number of large institutional investors, participating directly or through pools. This helps to explain why a small group of large public sector pension funds and/or their money management institutions have become so pivotal in the market, so quickly. Given a propensity for long time horizons, they are now well-situated to influence its future direction.

As mentioned previously, there is probably still space for more engagement by pension funds of all sizes through limited partnerships, especially in niche activity, such as mezzanine financing. Such partnerships are vital to the middle market for many reasons, not the least of them being facilitation of smaller dollar deals (e.g., below $50 million) not always preferred by the in-house programs of large investors.

CLMPC research has found that, along with enhanced capital commitments since the early 1990s, pension funds are broadening the scope of their investment activity. As in other countries (e.g., Australia, the United States), several of the largest funds have become especially attuned to non-venture private equity. At the moment, there is not enough data and analysis pertaining to the national middle market to confirm the meaning of these trends for financing established enterprises that are medium-sized or larger.

There is evidence of a gap, however, in the supply of mezzanine financing in Canada as compared to the United States — a concern considering this instrument's unique role in event-driven, middle market transacting. Pension funds may be in a good position to help fill this gap. Like life insurers and some of their counterparts south-of-the-border (see **In Debt to Pension Funds**), they may also be disposed to participating more in this market's supply of sizeable intermediate and long-term loans. In CLMPC interviews, several Canadian pension managers thought this plausible given shifts in the traditional make-up of fixed income assets.[78]

This said, a host of questions are without answers. Exactly what are supply trends relative to middle market demand in Canada? Are inordinate capital resources going to leveraged buyouts at the expense of other events and investment projects? Are restructurings getting their fair share? Is there a "crunch" in the provision of senior debt that hampers the modern development of medium-sized manufacturers and other traditional firms? How specialized are merchant banks? Are SMEs sufficiently aware of private placement options in the middle market? Are benefits being regionally-distributed? What role should pension funds play to address these and other market challenges? Such questions have been raised (and, to some extent, answered) in relation to the American middle market. Further research is needed to clarify these issues in a Canadian context.

The topic of pension funds in the middle market is further explored in **Pension Barriers to Financing New Economy Investment**.

6. Pension Funds and Public Equity Investing

Canada's public securities exchanges

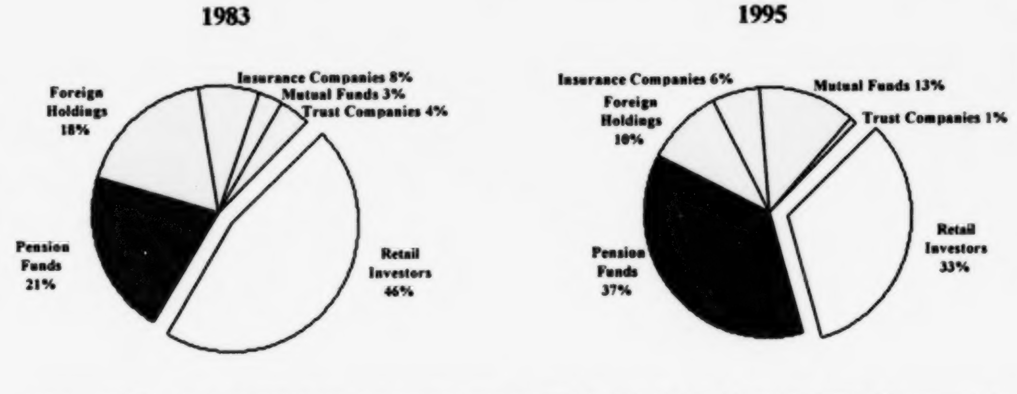
The strong, record-setting financial performance of Canadian and international public securities exchanges in recent years is no secret to anyone. Recent bullish markets are the result of a confluence of events and interacting factors. These include sustained national economic expansion, easier access to foreign capital markets, high corporate profits, low interest rates, a low Canadian dollar and demographic changes that have fuelled greater household demand for stocks. No less influential a variable is the dominance of institutional investors, including pension funds, in shareholding.

The vast majority of public securities trading in this country — approximately 80 percent, calculated on the basis of value — occur on the Toronto Stock Exchange (TSE). At around 15 percent of total trading, the Montreal Exchange (ME) is the second largest securitied marketplace, followed by the Vancouver Stock Exchange (VSE), the Alberta Stock Exchange (ASE) and the Winnipeg Stock Exchange.[79] Total listings, including inter-listings, vary widely between these exchanges and are changeable over time.

The market analysis company SEI estimates total capitalization of the four major Canadian exchanges to have been approximately $800 billion in 1997, a near doubling since the beginning of the decade. In a global context, Canada makes up over 2 percent of worldwide securities exchange capitalization that came close to reaching $30 trillion at the end of 1997.[80]

Appreciating public equity prices and other developments that have led to recent intensified trading, have also contributed to important structural shifts within Canadian exchanges. Among these is the changing composition of investors. Though exchanges have witnessed an unprecedented increase in retail sales, representing more participation by individuals, the impact of even this trend is bested by an enhanced pension presence. The TSE has reported that in the period between mid-1980s and the mid-1990s, pension funds replaced individuals as the top investor and shareholder group in Canada (see Figure 10). Total equity ownership of the former on the TSE is estimated to have risen to 40 percent by 1996.[81]

Figure 10
Estimated Total Shareholding in Canada by Institutional Investor, 1983 and 1995



Note : SEI Inc. has estimated pension fund shareholdings in 1996 to be 40% of total TSE 300 ownership

Source : TSE, 1997

Pension Activism, Made-in-Canada

University of Toronto professor Jeffrey MacIntosh notes, as in the United States, pension shareholder activism got its start in Canada in the last decade and perhaps specifically with fiduciary resistance to Crownex Corporation's 1986 plans for recapitalization. Since then, says MacIntosh, anecdotal evidence points to acceleration in the rate of high profile interventions on the same corporate governance issues receiving regular attention south-of-the-border (see America's Shareholder Activism). For instance, there were the efforts of the Caisse de dépôt and Ontario Teachers PPB to oppose concentration of top executive powers at the Royal Bank of Canada and the National Bank of Canada in 1997. To protect its existing stock values, the Caisse again exercised its clout in 1998 regarding the terms of Loblaw's bid to acquire the Quebec-based grocer Provigo.

Of course, such examples mask what is likely even greater incidence of formal and informal consultation and negotiation on governance concerns between pension investors and investee firm managers behind closed doors. This development, also a product of the 1980s, parallels the pronounced changes witnessed in corporate America, though it appears to have been prompted in Canada by fewer public battles. This reflects what many Canadian pension managers argue is a more typically consensual approach to resolving governance conflicts in this country. However, this may not always remain the norm. In 1998, OMERS flagged an interest in a more assertive shareholder stance, perhaps emulating some tactics utilized by CalPERS, such as publishing lists of under-performing firms. Other large public sector funds are similarly interested, citing research attesting to return maximization. Anecdotal reports also suggest more frequent participation by such funds in shareholder resolutions.

One sign of increasing activity among pension shareholders at home, and of increasing method in the process, is the crafting of corporate governance standards by the Pension Investment Association of Canada (PIAC), beginning in 1993. These standards are intended to advise members in the conduct of various shareholder initiatives, such as proxy voting, on key matters. Unique among countries where fiduciary awareness of new roles and responsibilities as significant minority owners of equity has recently come to the fore, PIAC principles are articulated under the following four topic headings:

- obligations of boards of directors, such as accountability and independence from management;
- executive compensation that is verifiably linked to long-term company performance;
- takeover protection, based on informed, independent procedures to approve major corporate changes, and that prevent the use of measures that may undermine stock values (e.g., poison pills);
- shareholder rights, including proxy votes, and the need to exercise these rights in defence of stock values and to guard against undue influence and potential conflicts of interest.

In a 1998 report, the Standing Senate Committee on Banking, Trade and Commerce re-inforced the significance of such guidelines, informed pension trusteeship, the need for independent directors on corporate boards and improved shareholder communications, among other imperatives, in its recommendations.

Sources: *The Financial Post*, "OMERS mulls more aggressive investing", March 19, 1998; PIAC, *Corporate Governance Standards*, 1997; Standing Senate Committee on Banking, Trade and Commerce, *Proceedings*, November 18 and 19, 1997 and *The Governance Practices of Institutional Investors*, 1998 ; CLMPC interviews, 1998

The reasons explaining this development have been alluded to previously. The asset base of employer-sponsored pension funds has grown dramatically since the 1980s due chiefly to increased asset allocations to public equity and more capital market participation among large public sector plans.

Stocks, large-cap and small

All mainstream exchanges function through an auction process for buying and selling listed securities that is negotiated and shaped by investment brokers, dealers, and specialty agents (e.g., registered traders) on behalf of investors. Auctions are, in turn, based on a familiar universe of common and preferred stocks. Types of stocks are determined by prices that mirror the underlying characteristics and financial performance of enterprises, histories of dividend payments and cyclical trends. The highest profile stock type is the blue chip, identified with the shares of the country's largest and most established corporations, such as those that constitute the TSE 35 Index.

Blue chip stocks also indicate market capitalization (i.e., overall dollar worth, determined by multiplying the stock price by the number of shares outstanding) that is, of course, quite substantial. In general, large-capitalization equity stocks (or large-caps) exist above a threshold of $1-2 billion — depending, of course, on what definition, or market index, one uses to distinguish them from small-capitalization equity stocks (or small-caps).

Again, depending on the point of reference, small-cap stocks can be said to exist below the $1 billion level, though as suggested above, some market analysts and practitioners believe stocks do not surpass low-capitalization until they have hit the $2-2.5 billion mark. Others refer to further size gradations, such as micro/small-caps which may reach uppermost limits of $50-500 million and mid-caps which may exceed these limits.

Assorted formal indices for benchmarking small-caps, such as the Russell 2000 in the United States, and at home, those established by CIBC Wood Gundy, James Capel Canada, Midland Walwyn and Nesbitt Burns, are among those that describe this market segment for trading purposes. Perhaps the most commonly quoted is the Nesbitt Burns version which consists of stock issues with a market float of less than 0.1 percent of the TSE 300 Index's total value — or a range of roughly $65 million to over $700 million in early 1998. Stocks are drawn from 400 enterprises and five different sector categories — consumer products, industrial goods, natural resources, energy and interest-sensitive industries.

Total capitalization of the Nesbitt Burns Index was $94 billion in 1997, as compared to the $651 billion TSE

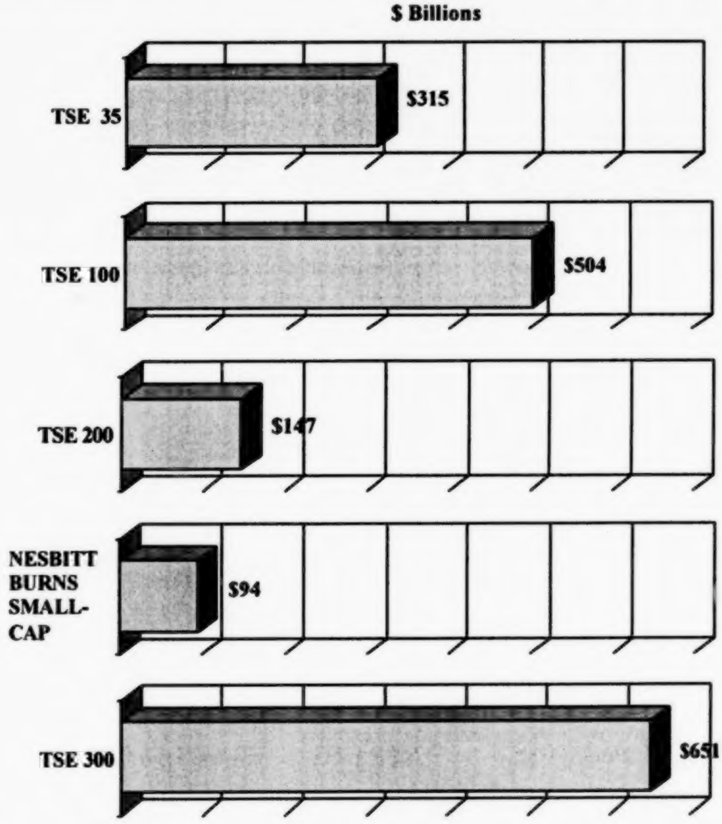
300 (see Figure 11). Small-cap stocks can also be found in some broader indices (e.g., TSE 200).

Considering the size effect of public equity investing is a fairly recent exercise. Over the past two decades, voluminous research literature has been produced, tending to confirm small-cap out-performance of large-caps, at least for stretches of five to seven years and in the longer-term. This conclusion uprooted notions of securities exchanges of near perfect efficiency and transparency, based on extensive publicly disclosed information about listings. Rather, small-cap stock behaviour appears to indicate a relative market inefficiency that, if properly exploited, can reap superior financial returns. The downside is, however, greater illiquidity, volatility and risk, compared to their opposites.[82]

Much of this phenomenon can be explained by the underlying business characteristics of small-caps, such as below average size, youth and, perhaps most meaningful of all, a propensity for exponential growth. The latter quality suggests why many small-cap stocks are also growth stocks, demonstrating significant price movements. Indeed, small-cap and growth stocks often align in emerging firms that are knowledge-based and technology-intensive and from other sectors with less profile in the industrial mix of large-caps. They may also be value stocks, or those priced to suggest neglect by investors that is mistaken due to strong underlying business and financial fundamentals.

Because there is less reliable information in circulation about low-price, small-cap stock issues, it must be collected directly by investors or their intermediaries. Richer data implies a reasonably accurate estimate of future earnings, since most of these stocks cannot be evaluated according to records of historic return patterns.

Figure 11
Estimated Total Capitalization of the TSE, by Market Index, 1997



Source : SEI, Inc, 1997

A revised view of stock size effects has led to pro-active investment strategies designed to compensate for less efficiency at the bottom end of public securities exchanges. Some market analysts refer to a "private capital market" aspect to these, given the onus placed on investigating and evaluating small-cap enterprises, selecting those that suggest financial promise — from a growth and/or value perspective — and closely monitoring development over time. Of equal importance in a trading environment characterized by fluctuation are risk control techniques, based on strict buy-hold-sell disciplines. Of course, these are management-intensive tasks and imply transaction costs.[13]

The colloquial market expression for this approach is "stock-picking." Tactical considerations associated with it are, not only what small-caps should be added to a portfolio, based on data gathering and analysis, but when, since reversals can be anticipated. Investing in low-capitalization probably also benefits from knowledge of change in the national economy and in specific industries, as the stock's underlying business is frequently sensitive to cyclical downturns and structural developments.

To a degree, such stock-picking methods apply to most trading. They are, however, most appropriate for value-adding small-cap specialists able to target prospects in a large population of issues, invest early, maintain a patient focus and, in some instances, help investee firms overcome immediate obstacles. Other investors may be more content to tap into the yields presented in market swings through broad public equity portfolios, both domestic and international, and passive indexed pools. Still others eschew small-cap investment altogether, believing that return cycles do not justify the costs and risks.

Needless to say, the art of small-cap stock-picking has attained some sophistication in the $12 trillion-deep (CDN$) public securities exchanges of the United States, due to advancement by such specialty managers as T. Rowe Price New Horizons Fund. The close integration of Canadian and American exchanges has ensured significant cross-border transfer of related investment methods and practices, where possible, in recent years.

The proceeding indicates a wealth of information concerning the nature and scope of small-cap public equity investing in Canadian exchanges. Unfortunately, this is not matched by comprehensive data regarding pension participation in this process. This topic comprises the balance of this section, however, based on the feedback of pension managers, market analysts and practitioners and some documents obtained from them by the CLMPC.

Public equity investing and the economy

Much of the energy and resources of public exchanges is channeled into the trading of share ownership that, in felicitous circumstances, bids values up. Today, close to one-quarter of all Canadian households, an increasing proportion of which are middle-income, benefit from the wealth generation capacity of this activity.

America's Shareholder Activism

Shareholder activism in the United States sprung to life in the 1980s when that country's largest owners of public equity — pension funds — first crafted anti-takeover resolutions directed at a small group of investee firms. In a milestone event, CalPERS, CalSTERS, SWIB, and the United Brotherhood of Carpenters and Joiners of America filed 1987 proposals to rescind "poison pills" or business defence mechanisms against unwanted acquisitions. Interestingly, poison pills remain a top target of mounting shareholder resolutions, along with a multitude of other corporate governance concerns, such as director elections, management powers, executive compensation, control transactions, major re-organizations and issues of good corporate citizenship.

At the forefront of shareholder activism in the United States are public sector and Taft-Hartley (jointly-trusteed, private sector) pension funds. This movement has been boosted by several legal decisions, including the 1988 pronouncement of the federal Department of Labor (DOL), agent for the Employee Retirement Income Security Act. DOL stated that fiduciaries are obliged under the law to vote pension shares on matters of corporate management and accountability to protect share values. This obligation was later extended to proxy, or trustee-delegated voting.

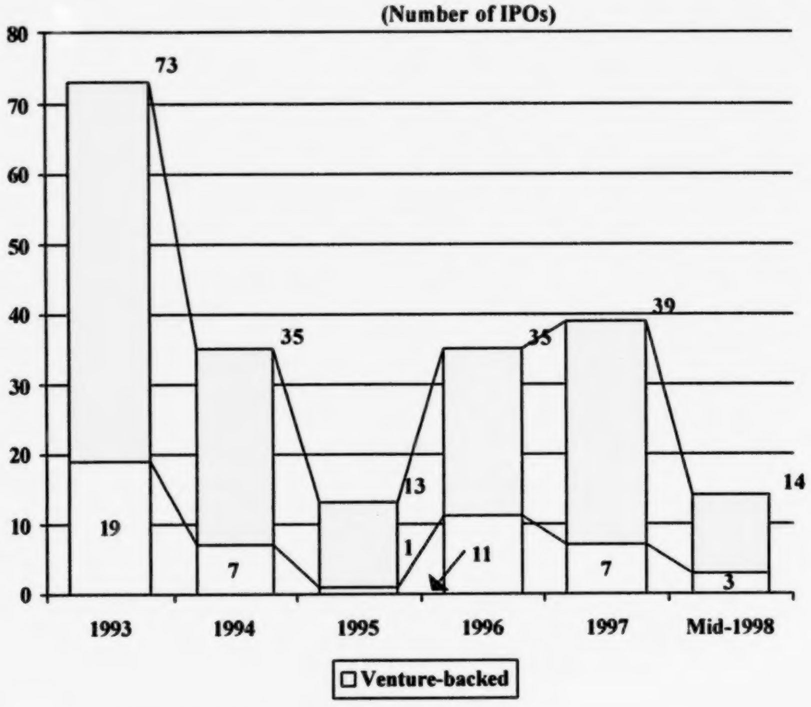
One result has been phenomenal growth in shareholder proposals from a mere smattering just ten years ago. In 1998, around 740 proposals were submitted (down from 820 in 1997) nearly one-half of which came to a vote at shareholder meetings. Leading 1998 topics included executive pay, declassification of boards, review of key business developments (e.g., sales, and restructurings) diverse voting issues and independence of board directors. Resolutions based on social objectives (e.g., environmental protection) are also prominent (see **The Newest Activists**). Many of these shareholder proposals are pension-led.

A standard-bearer in this new activist role is the Corporate Governance Program at CalPERS. CalPERS' aggressive assertion of its ownership rights over the past two decades has helped to prompt major changes in American boardroom relationships whereby regular, private consultations and negotiations on shareholder concerns or disagreements, previously almost unheard of, are today more common. Of course, this has occurred to avert resolutions and bad publicity over conflicts. CalPERS persists with high profile intervention, however, as leverage with perceived under-performing firms. One tactic is annual publication of a list of ten "corporate financial laggards" in the pension portfolio whose unsatisfactory governance behaviours are targeted for reform. This approach is supported by a 1995 Wilshire Associates study revealing a 52.5 percent increase in excess returns of selected firms (compared to the Standard and Poor's 500), following various CalPERS initiatives.

In 1994, CalPERS added "workplace practices" to its corporate governance priorities, noting that research clearly indicated enhanced firm-level performance from positive labour relations, fair employment policies, co-operation, worker empowerment and provision of training. Without the productivity benefits such factors yield, firms with substandard records were found to have weaker financial fundamentals.

Sources: CalPERS, *Corporate Governance*, 1998; IRRC, 1998; *Pensions & Investments*, "Pension funds led corporate governance revolution", February 9, 1998.

Figure 12
IPOs on the TSE,
Total and Portion Backed by Venture Financing, 1993-98



Note : IPOs reflect different TSE industrial categories with some exceptions (e.g., financial services, natural resources).

Source : Macdonald &Associates, 1998.

A more direct inducement of economic growth and job creation depends on the regularity of new security issues, such as initial public offerings (IPOs) or seasoned offerings by firms with established listings. The Investment Dealers Association of Canada reports current issuance as raising proportionally as much or more public equity capital to supply Canadian productive investment needs as is made available in the United States.[84]

While only a fraction of the entire SME universe ever reaches the juncture whereat they can enter the IPO market, the economic relevance of this act remains undisputed. One business advantage conferred by going public is access to potentially greater and more diverse supply through corporate stock and bond issues (as well as continued access to private placement). According to the results of a survey conducted by Professor Vijay Jog (Carleton University), this is the primary motivation of individuals owning private, closely-held SMEs, though others include less reliance on debt, equity cash-outs, liquidity, enhanced market information flows, improved business profile and credibility with customers and suppliers.[85]

Going public also brings closure to much long-term investment activity originating in private capital markets. Venture capital institutions depend on the IPO market as one means of liquidating their equity stakes in new and developing SMEs. Macdonald & Associates has estimated that venture-backed firms absorb, on average, almost $11 million in private equity prior to undertaking an IPO. As seen in Figure 12, such firms may, from year to year, represent a quite significant proportion of total IPOs. And, once in the IPO market, some have subsequently raised close to $17 million.[86]

A less-than-efficient IPO market creates impediments to venture investing and other private placement activity (including some in the middle market) or compels SMEs to rely on takeovers to achieve rapid expansion or other commercial goals. There is conflicting anecdotal and empirical evidence concerning the optimal effectiveness of the Canadian IPO market in facilitating a new generation of publicly-listed and traded enterprises.

On the one hand, the fixed transaction costs of public offering, both direct (e.g., underwriter fees) and indirect (e.g., SME resources expended on legal disclosure requirements) can be substantial. To alleviate costs, Canadian public securities exchanges do not feature the same range of alternative trading mechanisms as exists in the United States, such as an over-the-counter market comparable in proficiency to the National Association of Securities Dealers Automated Quotation System (NASDAQ).

On the other hand, a recent Conference Board of Canada study found that exchanges in this country are more supportive of SMEs, due primarily to less onerous listing strictures (e.g., minimum company size) than those south-of-the-border, including NASDAQ. SME listings are particularly well-expedited on the VSE and ASE.[87]

A good climate for IPOs, like that of recent years, will invariably spawn a fresh batch of small-cap stocks. Those firms that retain a strong growth orientation may quickly initiate a first round of seasoned offerings and follow an upward trajectory through exchanges towards higher-capitalization. The IPO market is a key source of intelligence used by investors and their agents to anticipate new listings that may proceed in this fashion and forecast their potential long-term earnings. Once spotted by investors — particularly small-cap growth and/or value specialists — the progress of some will eventually lead to their becoming blue chip corporations. All of this indicates how the SME growth and financing continuum evident in private capital markets (see Figure 6) can, for all intents and purposes, extend into the public venue.

Perhaps not surprisingly, some of the best performing of recent small-caps (some of which are now large-caps) have been not-so-distant past graduates of the venture capital market, such as COM DEV International, Hummingbird Communications, MOSAID Technologies and Trojan Technologies, or have otherwise been knowledge-based and technology-intensive. Indeed, Macdonald & Associates tracking of venture-backed IPOs since the early 1990s reveals regular out-performance relative to the entire IPO universe and the TSE 300.[88]

If recent trends on the New York Stock Exchange and the American Stock Exchanges provide any clues, such newly-listed, high-growth Canadian business may ultimately change the face of national public securities exchanges at the top. While American publicly-listed high technology firms were virtually unheard of in the early 1980s, in mid-1998 they comprised almost one-fifth of the entire Standard and Poor's 500 Index. This level of representation in the industrial mix of high-capitalization stocks is not yet apparent in Canada where public exchange indices remain comparatively weighted towards securities of traditional manufacturing, resource and service industries, some of which are low-growth or possibly in decline.[89]

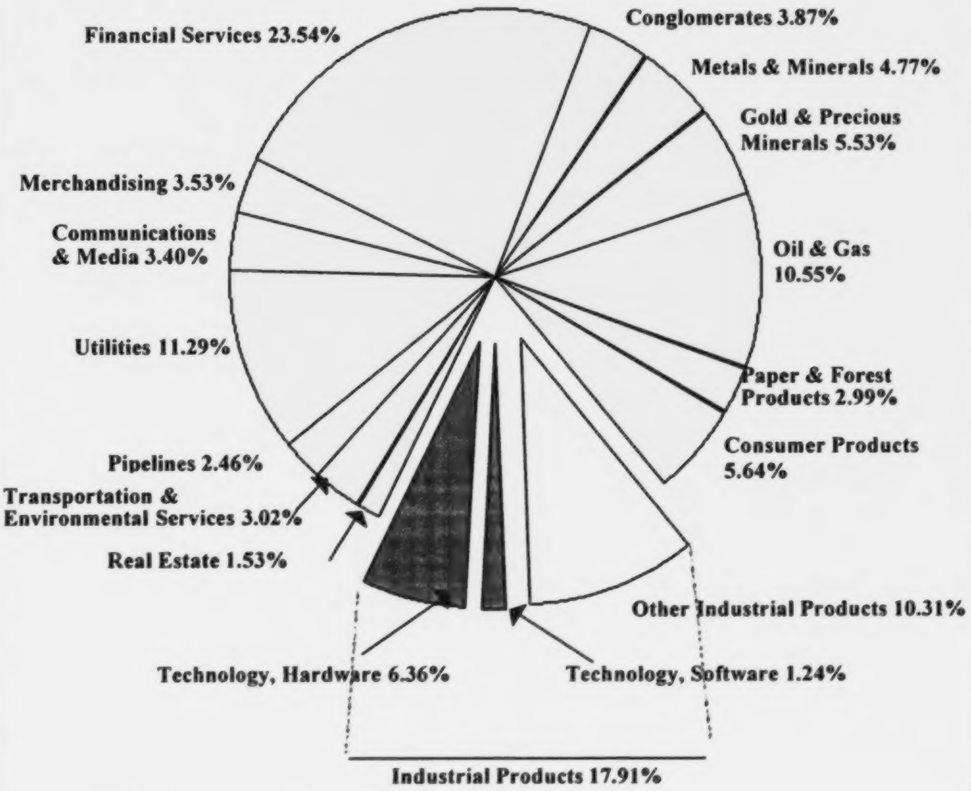
High technology stocks, by contrast, make up not much more than 10 percent of the TSE 300 at the present time. In early 1997, assorted hardware and software technology enterprises (e.g., computer products, electronics, information technology) constituted 7.6 percent of the index (see Figure 13), while other technology sectors (e.g., biotechnology and pharmaceuticals, telecommunications) reflect a small portion of such broad TSE 300 categories as consumer products, industrial products and utilities.

Of course, the implication is that the potential contribution of emerging industrial activity to future Canadian output, employment and incomes is in some measure bound up in the current experience of small-cap stocks. Will requisite investment reach them? Perhaps this cannot be taken for granted in public securities exchanges where there is an enormous and perennial concentration of capital resources in the highest quintile. This happens because the vast majority of individual and institutional investors, including pension funds, gravitate to the top. Such behaviour is certainly understandable given the qualities of large-cap, high-information, high-price stocks associated with corporations that are leaders in the national economy.

Pension funds and small-caps

While small-cap stocks have been around since time immemorial, it is only recently that evidence of their cyclical out-performance has endeared them to some investors. In the early 1990s, earnings from small-cap issues appeared to moving upwards once again, attracting the attention of Canadian pension funds and other institutional investors then proceeding to allocate more assets to public equity. The result was much more pervasive and sustained pension investment and what has been dubbed the "institutionalization" of small-cap ownership (or a component of what is now the institutionalized ownership of all public equity).[90]

Figure 13
TSE 300 Composite Index, Industry Type by %, 1998



Source : TSE Review, April, 1998

As was mentioned previously, small-cap pursuit is achieved in numerous ways. Several multi-product mega-firms (with both balanced and specialty capabilities) operating globally have pioneered design of pension investment styles based on comprehensive capital market research. This includes innovative approaches to small-cap investing. One leading, American-based mega-firm with a Canadian office offering asset management and advisory services to pension funds recommends investment modes to clients interested in this field. Such modes are designed to meet the particular needs and constraints of individual pension funds by combining different public equity stocks. Each mix is determined by stock weightings diversified according to size and according to type, such as growth and value stocks or the two blended together.[91]

The route taken to public equity investing will depend, of course, on the relative risk tolerance of fiduciaries at a given pension fund as well as their aims for cost-adjusted and risk-adjusted returns (see **Investing And Managing Pension Assets in Canada**). Some may adopt a passive strategy. Alternatively, others may be more active, but keep small-caps at the margins of portfolios. Still others may aim to "beat the market" and devote considerable resources to more aggressive participation in stock-picking.

This latter route entails use of specialists, situated internally or externally, to handle the information-intensive and management-intensive tasks of growth and/or value small-cap investing, and that can add value. In practice, many pension funds spread their small-cap asset allocations across a number of managers and pools exhibiting diverse investment styles and targets.

It was noted before that there are currently no Canadian aggregate statistics as yet confirming total pension investment in the low-capitalization end of public securities exchanges. The American-based mega-firm cited above reports that approximately 80 percent of its clients invest in small-cap stocks and that exposure for these averages about 5 percent of total portfolio holdings (though some clients will go as high as 10 percent). Naturally, exposure tends to rise with experience in this special sub-class of public equity assets.[92]

Such estimates cannot be viewed as the norm in the broader Canadian universe of pension funds, however. For many governing and managing fiduciaries interviewed by the CLMPC, 5 percent exposure to small-caps is the absolute maximum from a prudential perspective and very few funds, even among the most sizeable, are believed to have reached this threshold. Indeed, some large funds hold little or no small-cap stocks.[93]

In 1997-98, PIAC began gathering information on the small-cap holdings of its membership. This has proved to be a challenging endeavour, initially, considering that much of this sort of investing is indirect and undifferentiated in large Canadian public equity pools administered by external balanced managers. The PIAC database, unpublished to date, is based on estimates of holdings in TSE 200 and Nesbitt Burns stocks and may eventually provide a definitive snapshot of the acknowledged billions of pension dollars flowing in this direction.[94]

Responses from pension managers, market analysts and practitioners in CLMPC interviews suggested that pension participation may be especially vital to small-cap investment activity over time. As these stocks are predominantly illiquid, due to thin trading, and their out-performance of large-caps occurs over the long-term, investors must be patient. Due to low turnover in their public security holdings, pension funds reportedly exhibit more patience in exchanges than other institutional investors, such as mutual funds. When small-caps approach the end of a cycle, or otherwise show price volatility, pension funds are less likely to pull-out altogether than other investor groups. Instead, they tend to adjust by re-balancing the weighting of these assets in overall allocations.

A by-product of patience is the commitment pension funds have to enhancing shareholder value. Fund leverage as a significant minority owner is perhaps best illustrated in relation to blue chips and high profile governance issues pertaining to the roles, powers and decision-making of TSE 35 corporate boards of directors and managers.

Pension shareholder dispositions to such issues (some fiduciaries have articulated corporate governance policies) is, however, also relevant to small-cap enterprises. Given the illiquidity and risk of such stocks, a close, consultative relationship between investor and investee firm can be strategically important to long-term growth. For this reason, of all listed entities, small-caps may be among the most responsive to governance concerns raised by pension funds.[95]

Tracking of formal shareholder proposals in the United States by the Investor Responsibility Research Center (IRRC) sheds some light on what may be the incidence of small-cap targeting on corporate governance issues in Canada, if not today, perhaps in future. The IRRC database of 4,000 companies includes many listed on Standard and Poor's small-cap and mid-cap indices and the Russell 2000 Index. The IRRC reports that governance concerns addressed to small-cap firm management tend to be more performance-related than average, including some forwarded by such American pension funds as CalPERS and the State of Wisconsin Investment Board (SWIB).[96]

For further general discussion of this topic, see **Pension Activism, Made-in-Canada, America's Shareholder Activism** and **The Newest Activists.**

The following are illustrations of stock-picking strategies whereby pension participation in low-capitalization investing is direct and in-house (in the case of large funds) or indirect and externally-managed in a pooling vehicle (in the case of funds of all sizes).

(1) Direct pension participation

With well-developed internally-managed pools for small-cap investment, OMERS and the private sector pension plans associated with Bell Canada, illustrate participation that is direct.

Unlike most pension funds, OMERS has been investing in small-cap stocks over the past two decades. Today, this pension fund's strategy is to distribute its overall asset exposure to small-caps, currently at over $800 million — or close to 2.8 percent of total assets — to several managers and pools, most of which are external. In addition, OMERS retains an in-house dedicated pool. Established in the mid-1980s, the latter is based on a commitment of approximately $400 million and stock-picking beginning at a minimum of $50 million on the TSE.

The investment style selected for the OMERS dedicated pool has been described as value-oriented with regular attention also given to growth indicators. Practically speaking, the value approach to small-caps entails a "bottom up" search for stock prices that are low when compared with the worth of underlying business fundamentals, perceptible in assessed earnings prospects, internal capital structures, financial ratios and other value measures. Of course, value is discovered only through investigation and examination by specialty management, in this case, within OMERS. A key source of data relevant to any evaluation of whether certain small-caps suggest poor valuation in public securities exchanges is direct contact between OMERS representatives and firm owners and managers.

Stock-picking, Ethically

The American Social Investment Forum reports that a huge and expanding proportion of money circulating in public securities exchanges in the United States forms part of a "socially responsible" investment portfolio. In 1997, this included well over $500 billion committed to portfolios that were screened according to "ethical" criteria, including those of a growing number of pension funds.

Ethical screens may be described as the application of exclusionary standards to asset allocations and, in most instances, common stock-picking. In the United States, criteria has been found to be linked to diverse social concerns — from traditional "sin" activities (e.g., alcohol abuse, gambling) to environmental protection, gender equity, human rights, labour issues and military production. The latter tend to be found in the investment screening policies of Canada's $2 billion-plus ethical mutual funds.

This topic can mean different things to different people. For some, ethical criteria are essentially statements of principle intended to advise investment managers and prevent egregious errors. For others, guidelines must be applied more rigourously. It is argued by advocates of the latter that, to enhance corporate citizenship, timely divestment must occur, if necessary — a challenging maneuver for many pension funds — or coupling of screens with a strategy for managing assets and voting shares (also known as shareholder activism — see **The Newest Activists**. Screening can also be formal or informal. American pension funds have taken both approaches to excluding tobacco company stocks, seen in recent divestment/freeze initiatives of the Florida State Retirement Trust Fund and the New York State Teachers Retirement System.

Canadian pension funds have also shown interest in the philosophy and practice of ethical screening. For instance, the United Church of Canada Pension Fund is currently modernizing its guidelines after many years of applying to investing such standards as global human rights and sustainable development. In 1992, HOOPP similarly introduced four major criteria to its investment policy — ethical business practices, good labour relations, environment-friendly performance and a positive record on human rights. There is also private asset screening. Though specifically oriented to business concerns, Pensionfund Realty (see **Pension Funds and Real Estate Investing**) conducts an environmental audit on all potential property buys.

Most Canadian pension funds were first introduced to this topic in the 1980s when South African apartheid boycotts were of paramount interest. Since then, there appears to be increased discussion of the social concerns underlying ethical criteria in governing boards and committees. This is echoed in the OPSEU survey of labour trustees (see **Investing and Managing Pension Assets in Canada**,. Key proponents are unions, such as the Canadian Union of Public Employees that has been especially active in promoting investment screening on ethical grounds to public sector pension plans with affiliated members. American labour has taken the further step of initiating the Labor Sensitivity Index (1993) to highlight the screened stocks of unionized employers with positive records on assorted employment issues.

Sources: CUPE, *Submission on Ethical Investment to the Trustees of OMERS*, 1993; SIF and Co-op America, *Tobacco's Changing Context*, 1998; Walker and Hylton, "SRI in Canada and the US" *SIO Forum*, March-April, 1998; CLMPC interviews.

One of the enterprises OMERS has backed in its growth on the TSE from small-cap to blue chip is Linamar Machine, an auto parts manufacturer.

Naturally, OMERS and other pension funds utilize a multi-faceted strategy for investing in small-caps to make the most of continuous direct and indirect intermediation by various investors/agents and cyclical trade-offs in stock performance. For OMERS, additional reasons for operating in-house include cost-effectiveness, more capacity for active corporate governance, where necessary, and an improved network for acquiring intelligence concerning broad security price and trading developments in exchanges.[97]

The in-house money management institution BIMCOR also conducts a pool for dedicated small-cap stock-picking on behalf of the Bell Canada or BCE group of pension plans. In this case, however, the approximately $200 million allocated to this pool constitutes the full extent of BIMCOR's investment in this sub-class of public equity (or approximately 2 percent of total pension assets). This represents a highly focussed effort to obtaining optimal risk-adjusted returns from small-caps in the long-term, making the best possible use of expertise of personnel situated inside. Like OMERS, BIMCOR relies on the enhanced value-adding potential yielded internally by exercising close management, direct control and maintaining lower comparative cost structures.

The dedicated pool of BIMCOR got underway in the late 1980s, assuming a value strategy and related investment techniques that, like OMERS, also account for growth-related movements in stock prices. Micro/small caps are also targeted, to an upper limit of around $500 million, and found predominantly among listings on the TSE and ME. Because of the emphasis given to picking undervalued stocks wherever they may be discovered, small-cap investee firms in the portfolios of both BIMCOR and OMERS reflect quite broad diversification by industry.[98]

(2) *Indirect pension participation*

Use of external specialty small-cap managers on Canadian public securities exchanges has risen in the past few years, commensurate with intensified pension demand. Unfortunately, there is probably insufficient current supply of growth and value investors with a supplementary expertise in small-cap stocks in Canada to accommodate this demand, evidenced in the recent closing for business of several externally-managed pools. Van Berkom and Associates (Montreal, Quebec), for instance, was forced to turn away around $500 million in pension money in 1997.[99]

At $1.2 billion in 1998, Van Berkom's is one of Canada's largest independent pools specializing in small-cap stocks. Since 1984, this pool has operated with a growth investment mandate, concentrating on listed firms at an early stage of expansion through season offerings on Canadian exchanges and with revenues that range from $50-750 million. Van Berkom maintains a continuous monitor of low-capitalization stock issues beginning at a minimum of about $50 million, half of which comprise the portfolio at any one time. Small-cap investee firms come from various traditional or non-traditional industries, though many have been located in emerging, technology-intensive sectors, such as Gennum Corporation (an electronics and semiconductor firm) and JDS Fitel (a fibre-optics firm). Indeed, several firms in the Van Berkom portfolio can be identified as former venture-backed SMEs.

As a specialty investor in high-growth small-caps, Van Berkom aims to find business listed on the TSE or ME that is clearly positioned to benefit from prevailing economic trends. Approximately 80 percent of data collection and analysis are conducted internally. Van Berkom also performs the due diligence on prospective portfolio candidates among small-cap enterprises, based on forecasted earnings and other information relevant to determining rates of expansion. On occasion, external advice is solicited from experts on such matters as industry-specific developments (e.g., emerging high technology firms). Once Van Berkom invests, regular contact is maintained with business owners, managers and other informants (e.g., customers, and suppliers), for the purposes of performance monitoring.

The Van Berkom pool is predominantly pension-supplied. Participants include the public sector plans associated with Alberta Treasury's IMD and British Columbia's OCIO, as well as those of Avenor, Université Laval, McGill University, Ontario Hydro and Via Rail Canada. Pension funds contribute to the pool for periods of up to five years.[100]

Another small-cap growth investor and manager that syndicates pension assets as part of its operations is Bissett & Associates of Calgary, Alberta. Within this company's group of mutual funds are two low-capitalization pools initiated in 1992. The first, Bissett Small Cap Fund, targets stock issues of $70-500 million, while the second, Bissett Micro Cap Fund, concentrates on issues below this level to a minimum of $10 million.

Bissett balances investing with various strategic considerations and may include in its portfolio such targets as under-rated mid-caps, growing firms that are cycle-sensitive or in turnaround situations, and enterprises in traditional and non-traditional industries not always well-represented among small-caps. Natural resources are excluded — extractive sector stocks tend to be quite volatile — unless production is clearly manufacturing-related. Like Van Berkom, Bissett researches its stock-picking for evidence of strong potential financial gains on all major public securities exchanges in Canada. This said, there is a western Canada flavour to Bissett's mandate in its attentiveness to the progress of comparatively small-sized listings on the ASE.

The Newest Activists

Pension fiduciaries are not alone in speaking out more forcefully on corporate governance. A key stakeholder group that often advises, selects and monitors fiduciaries - organized labour - has also become active in this realm. In the United Kingdom, the Trade Union Congress (TUC) has adopted the *TUC Model Shareholder Voting Guidelines* to assist trustees on the exercise of their rights and obligations. The premise of these guidelines is that British enterprises that are accountable will be more efficient, to the mutual benefit of owner stock values, workers and the broader community. In turn, says the TUC, British pension funds must behave as stable, long-term investors and place an onus on fostering business prosperity, economic growth and job security.

The TUC guidelines offer a framework for trustee action on multiple governance concerns. It is recommended, for instance, that company reports be regular and detailed, that decision-making of boards of directors be transparent and that proposed takeovers and mergers be fully evaluated in advance. Shareholders should also approve executive pay schemes, ensuring that they are fair, performance-based and available in comparable form to employees. The TUC also believes that a firm's employment record should be held to certain standards, such as minimum pay and benefit levels, access to training, adequate health and safety and socially responsible practices, at-home and overseas. Finally, labour trustees must be prepared to back valid shareholder resolutions dealing with these priorities.

In the United States, the AFL-CIO has also published guidelines for labour fiduciaries. Like the TUC, the AFL-CIO emphasizes an active role for boards of directors on such governance issues as director elections, executive pay and major corporate transactions, including control changes (e.g., recapitalizations, re-incorporations, poison pills, altered board or management powers). Also like the TUC, the AFL-CIO asserts that pension activism should encourage positive industrial relations and corporate citizenship with respect to the environment, international human rights and communities of residence. Some in American labour have been assiduous in applying these principles, seen in the steadily increasing share of annual shareholder proposals forwarded by Taft-Hartley and union-affiliated funds on such current priorities as executive compensation, director accountability and anti-takeover measures. In 1997, the AFL-CIO set up the Center for Working Capital to act as a resource to this end, in part, by giving technical assistance and data to trustees and unions and by tracking the progress of labour-endorsed initiatives. One tool is the publication of annual key vote surveys designed to set new benchmarks for proxy voting.

There are signs that the labour movement in Canada may be heading in a similar direction. Like their American counterparts, Canadian unions and union centrals will sometimes join with church and non-governmental organizations in advancing social responsibility goals through concerted and strategic shareholder activism. For instance, the British Columbia Federation of Labour and its affiliates helped lead a shareholder resolution and lobbying campaign in 1998 on international abuse of child labour. To date, few Canadian pension-held shares have been voted in such events.

Sources: AFL-CIO, *Investing in Our Future: An AFL-CIO Guide to Pension Investment and Proxy Voting* 1990; Hutchinson, Moira, *The Promotion of Active Shareholdership for Corporate Social Responsiblity in Canada*, 1996; *Pensions & Investments*, "Special Report: shareholder activism", February 9, 1998; TUC, *Shareholder Voting: A Guide for Member Trustees*, 1996

Over 40 percent of the 1998 supply to the Bissett pools, estimated at around $700 million in total value, are derived from pension funds, such as Alberta Treasury's IMD and OMERS. Mutual funds provide the balance of capitalization.[101]

One of the few independent pools specially mandated to invest in low-capitalization public equity from the perspective of finding neglected value is Saxon Small Cap, of the family of Saxon Mutual Funds, and managed by Howson Tattersall Investment Counsel. Indeed, the latter was the first to found a mutual fund of this variety in 1985. At this early point, Howson Tattersall pioneered many of the small-cap stock-picking and management techniques meaningful to a value approach (discussed above in relation to BCE-BIMCOR and OMERS). At present, Saxon Small Cap targets under-priced stock issues of especially modest size — $200 million or less — on the TSE and ME.

About 50 percent of the supply to the Saxon Small Cap pool is derived from the assets of four pension funds, including Air Canada Pension Trust Fund and Petro-Canada Pension Fund.[102]

The local dimension

Considering that little more than one-fifth of Canadian public securities trading takes place off-site of the TSE, it is difficult to speak at length about a community or regional context for related pension investment trends, let alone on-going asset exposure to small-caps. Some market analysts and practitioners also argue that the function of inter-listing diminishes the meaning of such context. Of course, discussion is also constrained by the absence of national aggregate statistics on the topic.

Even if data were plentiful, what would be a reasonable framework for analysis? This question was raised in a 1997 study published by the University of Wisconsin-Milwaukee Center for Economic Development (UWMCED) that addressed, among other things, pension asset allocations to state-based, low-capitalization public equity. UWMCED reported that while the small/mid-cap stock investing of local private and public sector plans was below the national average, it was not clear this amounted to under-investment of disadvantage to the state economy. In the end, an ETI program was proposed (see **What's an ETI?**) that could include a small-cap index pool for developing Wisconsin enterprises.[103]

Given the importance of local public securities exchange activity to the economies of Alberta, British Columbia, Manitoba and Quebec — and, particularly, new and developing SMEs in these economies — there is probably something to be said for pension participation in small-caps at this level. This is certainly the view of the Caisse de dépôt, having given priority to re-inforcing the viability of Montreal as a Canadian and international financial centre. A substantial contribution to this aim is the Caisse's preferential location of securities transactions at the ME. For instance, in 1997, $7.7 billion of the money manager's volume of stock trading — of 67 percent of the total — was executed on that exchange (or over 8 percent of the total ME trading). Of course, small-cap stock issues are a component of this investing.

The Caisse de dépôt also provides support to the development of financial infrastructure, expertise and human resources in Montreal and elsewhere in Quebec. One goal of the subsidiary Services financiers CDPQ is to foster a larger and more viable provincial mutual fund sector that manages $15 billion within the next five years, by investing in firms with stakes in such funds. The Caisse also contributes to training and hiring programs relevant to the available pool of investment brokers, dealers and specialty agents.[104]

It was mentioned above that an array of specialty small-cap managers and pools that, to different degrees, depend on pension asset syndication operate within proximity of public securities exchanges located outside of Ontario. This fact is probably also of consequence here. Of course, the mutual funds of Bissett and Associates, capitalized in part by pension funds that include the Alberta Treasury's IMD, and active in the ASE universe of small-cap listings, is one such example. Bissett's locale also enables close working relationships with inter-listed Canadian business residing in Alberta and other western provinces expected to show significant economic development and diversification over time.

Some concluding thoughts

Canadian public securities exchanges are smaller, less liquid and, in some ways, less structurally evolved than those in the United States. Given that these circumstances impact on broad trading trends affecting enterprises of large market capitalization (e.g., comparatively high Canadian costs of equity capital), it should not be surprising that firms characterized by small-cap, low-information, low-price stocks will also encounter implicit challenges.

One of these may be limited pension participation. CLMPC research has found that a key impediment in this regard is insufficient supply of specialty management professionals with the skills and experience, or inadequate marketplace organization of those that exist, to facilitate pension in-house or external allocations.[105] Anecdotal reports suggests that the absence of available small-cap specialists and vehicles led to unsatisfied pension demand in the mid-1990s (though it is not clear this was a barrier for most of the very largest private and public sector funds). Another problem may be some pension fiduciary misconceptions about the inherent risks and transactional costs associated with holding small-caps or, at least, about how these can be effectively institutionally managed. This is unfortunate considering the long-term focus pension funds can apply to this segment of public equity investing that requires it most.

Along with their cyclical and long-term financial out-performance, small-caps are under-appreciated as a public market avenue for new and developing business and particularly SMEs emerging from private capital markets. To the extent that there are structural obstructions to investment in them, possible collateral benefits to Canadian economic growth and employment may not fully materialize. If this is so, the lost opportunity may be most keenly felt in local and regional economies seeking to diversify.

The advance through exchanges of growing knowledge-based and technology-intensive enterprises — well-represented among small-caps — but not, as yet, in the TSE 300 Index — may be of pre-eminent concern here. When insurmountable difficulties are encountered by those that retain commercial viability, of course, an alternative remains in privately-placed debt and equity (see **Pension Funds and Middle Market Investing**).

If American shareholder activism trends are any indication, Canadian small-caps enterprises may benefit from a more universal casting of the net by pension funds attending to matters of corporate governance. Indeed, such governance concerns may become increasingly integral to the value-adding strategies of specialists that can assist investee firm development. Research is accumulating in Canada and the United States that testifies to the performance bonus achieved by thoughtful and concerted pension efforts in managing assets in this fashion.[106]

A more precise understanding of the role played by Canadian pension investment in small-cap public equity awaits more and better aggregate data that is made publicly-available. Detailed disclosures of the holdings of pension funds in the United States seems to have informed public policy discussion of this subject there. Perhaps PIAC's recent survey work or other market analysis sources will help rectify this situation in future.

7. Pension Funds and Real Estate Investing

The three sections that precede this one have dealt with pension involvement in private and public capital markets that, in one fashion or another, facilitate the financing of new and developing SMEs and larger firms in the context of Canadian economic change. The real estate market (or markets) instead consists of investor purchases of land or property and development of these. Development or redevelopment refers to the financing and undertaking of construction of new stock of real estate or renovations (e.g., improvements, up-gradings, expansions) to existing stock. Properties and development transactions can be either residential (i.e., owner-occupied or rental housing) or non-residential (i.e., commercial, industrial or retail sites).

Real estate investing is included here because of its' important position in the Canadian economy. Valuations of national real estate assets attest to this importance. One estimate put the market value of total per capita real property in Canada, both residential and non-residential, at $1.6 trillion in 1992.[107] In addition, investment activity that adds to, or augments the value of, these assets can produce exponential collateral benefits.

Canadian real estate markets have undergone dramatic structural changes in recent years. Strong economic growth, population and labour force trends drove a near forty-year span of fairly continuous prosperity since mid-century, climaxing in the boom of the 1980s. At that juncture, the boom period was succeeded by a bust that many economists attribute to a cyclical glut in development. University of Toronto professor David Foot believes that the bust also had non-cyclical causes founded in demographic shifts of consequence to residential and non-residential demand. Foot and other observers have also noted the growing impact of innovation and technological change on demand for commercial and industrial properties. Computerization, telecommunications and other information technologies, for instance, have permanently altered the productive and spatial requirements of business infrastructure.[108]

Another variable is the recently reduced fiscal capacity of government at the federal and provincial levels. Historically, public policy has aimed to stimulate private sector investment in residential housing or spent directly to create new dwellings or rehabilitate established ones, especially for low and middle-income households. The 1990s have been characterized by a restricted government presence in developmental housing, with very few private supply sources ready to fill the gap.

All of this restructuring has had, and is expected to continue to have, an inordinate impact on investment in real estate. Since the late 1980s and early 1990s, Canadian markets have contracted in size, realty companies have disappeared or merged with others, investors have departed or reduced their financial stakes. Needless to say, much residential and non-residential development has also been neglected. Only since 1993 has there been some revival. Among those contending with the vagaries of this changing market environment — cyclical and structural, immediate and long-term — are employer-sponsored pension funds that have historically maintained some exposure to this asset class.

The following is a brief exploration of the nature, scope and dimension of contemporary real estate investing in Canada with special attention given to the role assumed by pension funds.

Aspects of real estate investing

Real estate investing is fundamentally a private capital market activity. As such, it shares in practice many of the same characteristics of markets for private debt and equity placement already discussed and, by extension, many of the same barriers to entry and sustained involvement by pension funds and other institutional investors. In *The Role of Real Estate in a Pension Portfolio* (1994), professors Stanley Hamilton and Robert Heinkel (University of British Columbia) detail these characteristics, and others more peculiar to this investment activity, as well as some of the ensuing impediments to pension participation, in a Canadian context.[109]

The first feature of investment in real estate identified by Hamilton and Heinkel is its relative immobility, meaning that assets such as land, large structures and other fixtures established on properties (e.g., buildings) are, for all intents and purposes, permanently rooted in their respective locations. Hence, while the market for direct ownership of real estate is national and international, its operation is uniquely local. This suggests that the information intensity of mostly private real estate investing is heavily determined by geography as Canadian community and regional sub-markets are frequently distinct with regard to the nature of properties, demand and supply trends, economic fundamentals and other area-specific variables. As a consequence, the value of real estate assets in one sub-market may be completely different from that in a neighbouring district.

Of course, it is the transactional job of agents and intermediaries to collect precise and up-to-date information relevant to pricing, operating costs and investment opportunities. To do this, such professionals must be knowledgeable about local sub-markets across the country and incur quite substantial, up-front expenditures.

Another feature of real estate assets is their long lifespans. Generally speaking, residential, commercial and industrial properties and adjoining structures enjoy, as physical entities, long-term duration in a given locality. This, combined with their relatively immobility, suggests that the current price of an individual property will be inordinately affected by the quality of surrounding properties, and vice versa. Of equal importance, is the economic lifetime of periodic structural alterations or improvements on properties, or complete replacement of structures, that can augment or restore underlying value and generate returns to owners and investors.

Real estate is further characterized by low rates of turnover in ownership. Hamilton and Heinkel estimate the average holding period to be approximately ten years. Limited turnover is matched by fairly long periods for marketing both residential and non-residential properties for new owners. These traits of investment in real estate, like illiquid investment in other private capital markets, have critical ramifications for financial performance measures that may not be simply or frequently provided.

In the case of real estate, however, there is a traditional and well-developed source of price data and property valuation provided by a industry of specialized and independent market analysts and appraisers. A prominent and commonly-utilized Canadian measure and benchmark of returns over time is, for example, the Morguard/Russell Canadian Property Index (an amalgam of two previously distinct indices). Among the fourteen entities responsible for $15 billion in real estate investing represented in this index, there are large pools and syndicate operations (e.g., Morguard Investments and Penreal Capital Management — see below) and subsidiaries (e.g., the Caisse de dépôt — see below — and OMERS) utilized by pension funds and other institutional investors. Reports are made quarterly.[110]

Along with the information-related costs, aspects of real estate investing can include exceptionally high capital costs influenced by local conditions. For the most part, this is due to the sheer size and scale of properties being purchased, especially those that are commercial or industrial. On the other hand, this also suggests one of the chief attractions of real estate markets for institutional investors, given the opportunity for allocating a large proportion of assets to a few projects over the long haul. The disposal of holdings also involves costs that rise with rates of liquidation.

Finally, the procedure of supplying marketplace responses to real estate demand shifts is a slow one. Major development and re-development projects tend to occur over several years because of the time required for the processes of planning, approval (by municipal and other governments, according to certain public standards for zoning and construction, among others) and implementation. They are longest in the case of large, non-residential properties. When combined with local circumstances, this factor can introduce a degree of uncertainty and risk to investment activity.

Taken together, real estate's intrinsic characteristics of relative immobility and durability, and market characteristics of comparative illiquidity, high costs and some risks, indicate the challenges to investors interested in high yields and the historic advantage offered by this asset class as an inflation hedge.

One key to overcoming challenges, already alluded to above, is the use of real estate professionals with the specialized skills and localized experience to actively select and manage assets in distinct markets or provide advice on these matters. As in other Canadian private capital markets, such are not in great abundance. Pension analyst Keith Ambachtsheer has noted this gap, along with the further observation that some in the finite pool of value-adding investment specialists may not be sufficiently familiar with the needs of potential clients among pension funds.[111]

The structuring of financing in real estate transactions can often be complex. Depending on the transaction's nature (e.g., purchases of land tracts or properties, development deals) and possible co-investment or partnership requirements, one or several of a wide range of debt and equity instruments may be utilized, as well as mortgages, mortgage-backed securities and mortgage loans.

There are also various methods for conducting real estate investment at-a-distance using public securities exchanges. For example, it is possible to simply purchase shares in a publicly-traded realty company with its own portfolio of high-grade property holdings, such as Trizec Hahn Corporation (Toronto, Ontario). A drawback to this option is the limited number of these listed on Canadian exchanges.

Another alternative is the real estate investment trust (REIT), a publicly-traded, open-ended vehicle for raising capital to invest in mortgages and diverse residential and non-residential property types in different locales. A multi-billion dollar phenomenon in the United States, REITs have also gained popularity in Canada among institutional investors (especially smaller ones with little ability to participate directly) due to their comparative liquidity and avoidance of some of the impediments described above.[112] This said, REITs and other forms of securitied real estate emain linked to these markets and must, as a consequence, rely on specialty investors and managers to succeed in the end. In addition, this approach resembles stock-picking and may result, some market analysts and practitioners argue, in a higher level of returns volatility than is common in direct, illiquid investment.

Real estate investing's economic role

Spending on real estate development or redevelopment is a potent means of creating jobs and relatively large multiplier spin-offs, particularly during upswings in economic cycles. Much North American research has confirmed that, depending on the magnitude of investment projects, developmental real estate can produce both general and industry-specific effects.

A recent macro/micro-economic simulation performed by Informetrica for the Canadian Mortgage and Housing Corporation provides one demonstration of this point. Assuming a $1 billion financing of additions or alterations to housing stock over two years, gross domestic product and aggregate employment outcomes in the national economy were found to occur during both the initial investment and in further induced expenditure.

Informetrica lists specific beneficiaries as including the Canadian construction industry that captures over $330 million of the total initial amount in the new construction scenario. Somewhat less — amost $260 million — is captured by this industry in the case of renovations of existing property. Manufacturing industries that are the source of materials also stand to benefit in both scenarios, so long as domestic inputs are preferred over imports. Such leakages may be more prevalent today because of the influence of liberalized trade.[113]

By extension, such investing provides its biggest direct and indirect employment yields to construction and affiliated trades and assorted downstream manufacturing and service trades (again, assuming low reliance on imports). This includes such occupations as carpenters, electricians, iron workers, labourers, masons, operating engineers, painters, plasterers and lathers, plumbers and pipefitters, sheet metal workers and support personnel, both on-site and off. New construction and improvement/up-grading projects are, of course, most welcome to the large share of this work that is seasonal and vulnerable to cycles.

To the extent that pension participation in real estate markets features a developmental component, similar economic effects are feasible. This has been illustrated in empirical assessments of American real estate investment deals over a fifteen-year period and made by a pension-supplied developer located in California. Between 1981-1996, over $4 billion in spending on residential and non-residential construction was estimated to create over $10 billion in productive activity. This included total working time of approximately 230 million person-hours, of which construction workers captured almost 90 million. These data were produced using the econometric model of the Construction Industry Research Board in the United States and are said to be typical.[114]

Another essential economic and social outcome of such investment activity is improvements to the quantity or quality of housing stock and to business and public sector infrastructure. The California developer's financing, cited above, was channelled to new single family dwellings and new buildings for commercial tenants. Another by-product may be increased contribution levels to the pension suppliers of capital if employment generated includes working plan members. Naturally, this is one rationale for pension asset syndications for real estate investing promoted by jointly-trusteed and union-directed funds representing construction and supplier industries (see references to Greystone Properties, Mortgage Fund One and **Their American Cousins** for examples).

In recent years, cutbacks to expenditure programs sponsored by Canadian governments have raised concerns about the availability of affordable, quality housing in for-profit, non-profit and co-operative sectors, in communities and regions throughout the country. One trend flagged to be of especially great concern has been little new provision of moderately-priced rental apartment units, or renovation of aging ones, in the current decade. In addition, local and provincial governments give some priority to new construction or alteration of commercial, industrial and retail properties. Investment in these may help attract new business or help retain existing enterprises and thereby contribute to a region's economic base.

While pension asset allocations to real estate in aggregate have been declining (see below), there have been tentative signs of renewed interest. Moreover, fresh investment initiatives directed at perceived gaps in development (e.g., affordable housing) appear to be gaining ground in both Canada and the United States. Impetus behind these comes primarily from construction industry pension funds, alluded to above, and, more recently, public sector funds, sometimes accompanied by the fiscal leverage or stimulus of government.

Infometrica's Michael McCracken and Carl Sonnen have also provided analysis of the large economic and job multipliers associated with investing in the development of transportation, communications and environmental infrastructure, both private and public.[115] An overview of this topic, and its connection to Canadian pension funds, is given in **Infrastructure: The Newest Asset Class?**.

Infrastructure: The Newest Asset Class?

Like some types of real estate (e.g., affordable housing), infrastructure — generally defined here as physical facilities that move people, goods and information, as well as energy, waste and water — has historically required some measure of government spending to be created or renewed. Unfortunately, fiscal constraints have limited public policy's efforts in the 1990s, causing an investment shortfall estimated by the Federation of Canadian Municipalities (FCM) to stand at over $20 billion. There are potentially severe economic and social costs in this neglect, particularly in urban communities in the country. Considerable North American research studies have over the years attested to the contribution of core physical infrastructure to business growth, productivity gains and sustainable development, not to mention jobs associated with the planning, building, operation and maintenance of bridges, roads, sewers, water systems and other public works.

Apparent gaps in the financing of infrastructure investment has encouraged a search for alternative, private supply sources to tap into, such as pension funds and other institutional investors. In some cases, this has co-incided with expressions of pension fiduciary interest in the earnings and diversification potential of this new asset class, net of costs and risks similar to those intrinsic to real estate and other private capital markets. In the United States, the 1993 Commission to Promote Investment in America's Infrastructure recommended that government actively facilitate the surmounting of pension barriers. This might include leveraging supply through the offer of direct and indirect subsidies or a focus on market development and efficiency issues, such as the provision of adequate numbers of specialized advisors and agents to investors. The AFL-CIO has made comparable proposals, including an ETI approach (see **What's an ETI?**). The result has been some early American pension participation, especially among large public sector funds, utilizing both debt and equity financial instruments.

In Canada, large public sector pension funds are also seizing the initiative. In 1997, OMERS called for more national infrastructure revitalization based on new and strategic government-private sector partnerships. At the same time, OMERs determined to embark on its own infrastructure investment projects in Ontario municipalities and elsewhere, calculated to achieve high yields, chiefly through private equity financing, and according to conventional risk-reward criteria. The pension fund has set up an internal program for this purpose, CFMC Fund Management, which is presently investigating a range of deal options.

Infradev and other subsidiaries of the Caisse de dépôt have also started investing recently in Quebec infrastructure development, as well as in selected deals in Asian, European and Latin American locales. Some spending on infrastructure also occurs currently under the auspices of large-scale real estate deals, such as redevelopment of portside facilities (relevant to multiple forms of private and public transit) at Vancouver's Canada Place, currently underway with the backing of pension-supplied Greystone Properties.

Sources: Bourgeois, Jean-Guy, Infrastructure, the Economy and Pension Funds, 1998; FCM, Rebuilding for a Competitive Canada, 1993; Mintz and Preston, Infrastructure and Competitiveness, Queen's University, 1993; Richmond, Dale, Private Capital and Municipal Infrastructure: A Two-Way Street, OMERS, 1997

Pension funds and real estate: then and now

Though often described as an alternative or non-traditional asset class, real estate is a conventionally significant source of Canadian pension portfolio diversification away from more predominant allocations to stocks, bonds and cash. Despite its private capital market basis, a moderate amount of exposure to real estate has been regarded as prudent by most pension fiduciaries for several reasons.

Two reasons, mentioned above, are that most real estate holdings confer the advantage of less volatility compared to publicly-traded securities and that asset values tend to track inflation. Low inflationary pressures have modified the utility of the latter variable, but this is made up by a third motivating factor — solid financial returns (income plus capital gains) over the long-term. There is evidence that these have been improving since the early 1990s and, in the past couple of years, fell between the higher returns of stocks and the lower returns of bonds.[116]

The aggregate exposure of pension funds to this asset class was somewhat greater in the 1980s than it is today. As stated at the outset, such investment activity benefited from an inflated boom cycle in all real estate markets during the previous decade. It is well-known that reverberations of the worldwide bust at the decade's end led to severe erosion of asset values, write-offs and disruption of the balance sheets of bank and non-bank financial institutions and institutional investors caught with over-exposure.

Despite owning comparatively few properties, pension funds were not immune to this event. The financial and legal problems besetting OMERS Realty Corporation over the status of holdings and valuations in recent years, for example, are said to have originated in this bust and in the Canadian economic downturn that came afterwards.[117]

One result of this experience was a gradual reduction in pension participation in Canadian real estate markets. This is less obvious in Statistics Canada data for the universe of trusteed pension funds (see Figure 4), showing overall asset allocations to real estate and lease-backs to hover at around 2 percent and 3.5 percent between 1986 to 1996. In the *Benefits Canada* profile of the 100 largest funds (see Figure 5), however, allocations are revealed to have declined precipitously since the recession, from 6.7 percent in 1993 to 4.2 in 1997. Another and more pressing contributor to this drop has also been, of course, strong equity price appreciation in public securities exchanges.

Indications are that real estate began a financial rebound in 1993, enjoying a renewed influx of capital resources from diverse supply sources, including some pension funds. This is certainly reflected in aggregate dollar commitments among the largest funds — rising to almost $19 billion in 1997 — that belie the current observed lows when expressed as a percentage of total assets. These newest asset allocations are attributed to a handful of large public sector pension funds, such as those associated with British Columbia's OCIO. Engagement in real estate investing differs conspicuously among Canada's most sizeable private and public sector funds (i.e., over $5 billion in assets), from OMERS exposure of 12.5 percent to the 3 percent of Ontario Teachers PPB.[118]

Some market analysts and practitioners believe that the market's recovery warrants some restoration of higher levels of pension investment in real estate. Hamilton and Heinkel argue that the average pension portfolio might reasonably include 5 percent in such holdings. More risk tolerant pension fiduciaries might even raise their threshold for this asset class as high as 15 percent.[119]

Models of pension participation

Generally speaking, pension investment in real estate tends to follow a buy-hold-sell pattern in relation to existing properties or property shares that are diversified geographically. Periodic spending on minor or major expansions and refurbishments of these, and involvement in larger-scale developments, also takes place in this process. Portfolio holdings are commonly diversified by property type, though real estate of paramount financial interest is non-residential, such as factory sites, hotels, industrial parks, office buildings, retail outlets and shopping centres. Such large properties imply a commensurate opportunity for allocating substantial assets. Pension funds may also invest in land, some residential housing and infrastructure (though this rare and often treated as a distinct asset class (see **Infrastructure: The Newest Asset Class?**).

In the past, it was standard practice for pension fiduciaries to buy into office buildings or other commercial complexes within close proximity. This has certainly changed over the years due to the ebb and flow of local sub-markets according to regional economic circumstances. Pension funds are now more likely to diversify nationally and, in some cases, internationally, to obtain risk-adjusted returns from identified boom cycles then unfolding in a given sub-market (e.g., British Columbia, in recent years).[120]

There is a much broader menu of alternative means and structures to expedite pension participation in real estate than are found in other private capital markets (though these are fewer in Canada than in the United States). Pension funds can participate directly, usually through a separately-capitalized subsidiary, and through co-investment with other funds, institutional investors, and developers or realty companies. The management-intensive tasks of evaluating, acquiring, leasing, managing and disposing of assets are delegated to specialists familiar with local conditions and property types, situated internally. This may include hands-on, daily management of properties (e.g., maintenance, marketing, tenant services) or developmental undertakings. External expertise is also frequently contracted for advisory and intermediary purposes.

Most of Canada's very largest private and public sector pension funds invest directly through subsidiaries. Smaller funds instead engage indirectly through vehicles that syndicate pension assets as well as pension ownership of properties in a given real estate portfolio. There are several ways of accomplishing this, however, Hamilton and Heinkel report that the version that receives most subscriptions is corporate structures wherein pension shareholders share costs and risks. Within such structures, participatory arrangements vary. Some feature closed-end pools to accommodate illiquid investing or open-end pools that permit more regular liquidations.[121] Models may also vary according to the latitude given specialty managers to perform, on behalf of pension suppliers, the duties described above.

Both direct and indirect systems are in evidence in Canada.

(1) Direct pension participation

Two examples of the long-standing practice of large Canadian pension funds to conduct real estate investment in-house are Canadian National Railways Pension and the Caisse de dépôt. With total allocations of close to 4.7 percent and 7.5 percent of total assets, respectively, these two fall somewhere in the middle of the spectrum of exposure among the most sizeable funds in the country.

With a long history of investing in real estate markets, Canadian National Railways Pension currently manages a portfolio, valued at $465 million, that is fairly representative of the direct approach assumed by pension funds. Key to this approach is the location of investment specialists, processes and resources internally and use of a wholly-owned subsidiary. In the case of Canadian National Railways Pension, it is Canapen Group of Real Estate Companies that administers residential and non-residential property and that executes acquisitions, dispositions and other major fiduciary decisions. Holdings may also be said to be generally representative given their diversification by type and locale. Canadian National Railways Pension has full or partial ownership in office and mixed-use buildings, such as 100 percent shares in the Hudson's Bay Centre in Toronto, Ontario, retail outlets and land. These may be found in British Columbia, Alberta, Ontario and Quebec. Most retail is indirectly-held, through investment in the publicly-listed Cambridge Shopping Centres.

Canadian National Railways Pension also participates in development from time to time, always as co-investments and partnership arrangements with established realty companies. One example is the Montreal-based complex for the International Civil Aviation Organization of the United Nations, construction for which was finished in 1996. The large parcels of land owned by the pension fund may be sites of similar investing in future.[122]

After years of relevant investment experience, the Caisse de dépôt established in 1993 its Caisse Real Estate Group, comprised of five internally-managed pools featuring distinct investment mandates and operations. Ivanhoe is responsible for the acquisition, holding and development of shopping centres in urban areas in Canada and the United States. SITQ Immobilier focuses on management and development of office buildings, industrial parks, usually in partnership with other investors. Cadim specializes in residential properties, also with partners, while Cadev is charged with managing and developing Caisse-owned land. Finally, Hypotheques CDPQ holds residential and non-residential mortgage loans and related securities.

Taken together, the Caisse de dépôt's real estate and mortgage portfolio was valued at $4.8 billion at the end of 1997. Approximately 60 percent of investment was property-holding, primarily geared to commercial and industrial sites, and nearly 25 percent in mortgages. As suggested above, subsidiaries undertake some financing of development, redevelopment and up-grading activity, such as a residential project to build 300 houses on Nun's Island and a proposed plan for revitalizing Montreal's international district through the co-ordinating entity Quartier international de Montréal. Related capital spending, along with regular lease-hold improvement projects, totaled almost $80 million in 1997.

In 1997, an internal review of the Caisse Real Estate Group concluded with subsidiary restructurings and wider geographic dispersal of holdings, both nationally and internationally, to account for market trends. At the end of 1997, over 42 percent of total real estate investing was located in Quebec and over 15 percent in the rest of Canada.[123]

(2) Indirect pension participation

Since its inception in 1975, Morguard Investments (headquartered in Toronto, Ontario) has been one of Canada's largest syndicators of the assets of pension funds and other institutional investors for the purpose of real estate investing. Indeed, pension participation has been central to Morguard's mandate of acquiring, holding and developing non-residential properties of all kinds in urban locales in western Canada, Ontario and Quebec.

Morguard has a unique approach to facilitating pension involvement. A primary vehicle is Pensionfund Realty, a corporate structure currently owned by thirty-three pension funds, most of which are medium-sized to large. Included are such private sector plans as Domtar Pension Fund Investments, General Motors of Canada, Hudson's Bay Company Pension Fund, Shell Canada Pension Trust, Telus Corporation Pension Fund and others from manufacturing, resource and service industries. Among other public sector plans, there is CBC Pension Fund Administration, Hydro-Quebec Fiduciarie, HOOPP, Manitoba Civil Service Superannuation Board and the Ontario Hydro Pension Plan. At the end of 1997, the investment portfolio of Pensionfund Realty was valued at $1.2 billion, based on a total of 138 properties. This includes nine new acquisitions made that year. Approximately 42 percent of total holdings are retail outlets, 32 percent are office (and mixed-use) buildings and 26 percent are industrial complexes.

Morguard is Pensionfund Realty's manager. With respect to adding new assets, it undertakes market research of potential real estate opportunities with the aim of identifying existing properties of good value or that may be undervalued. Morguard also investigates prospects for development and redevelopment, including new construction on acquired sites, usually in the business cores of Canadian cities. Purchases and projects deemed viable, income-generating and consistent with pre-determined criteria are brought to Pensionfund Realty to explore interest among a group of pension shareholders seeking increased exposure. This is followed by structuring of a co-investment project, on a per deal basis, using different combinations of debt and equity financing.

Morguard also sponsors a REIT, first offered publicly in 1997, that invites participation by pension funds and other investors. Listed on the TSE, the investment activity of Morguard REIT observes the same diversification strategy, based on geography and non-residential property types, as Pensionfund Realty. Portfolio holdings were sixty-four at the end of 1997, valued at over $475 million. 10 percent of REIT earnings are retained for re-investment at the time of regular distributions.[124]

Beginning in 1989 as the $27 million Vancouver Land Corporation — a government and private sector partnership intended to supply more new and affordable rental apartments in the city — Greystone Properties is today a real estate developer and manager with an even broader, full-service mandate. Now operating with over $300 million in assets, it has supplemented original goals with targeted financing of other types of residential construction, such as new multi-family, for-sale housing, as well as commercial, industrial and infrastructure investing in urban and rural communities throughout British Columbia.

Greystone Development Corporation assists projects across all phases of development, from design, planning and financing (through loans and mortgages) to completion of construction. In the majority of cases, Greystone Realty Services continues to manage the property thereafter. Among Greystone's new activity is urban neighbourhood planning, reflected in the creation of rental and owner-occupied homes, as well as community recreational facilities, in the Collingwood Village district of Vancouver. More recent still is its role in the expansion and retrofitting of the convention centre at Canada Place that includes significant redevelopment and integration of Vancouver portside structures relevant to multiple forms of transit.

In 1998, the Greystone portfolio comprised over a dozen projects (including those identified above), of which approximately 80 percent are oriented to rental and for-sale housing constructions and renovations, while commercial/industrial developments make up the balance. All portfolio investment activity is undertaken following an evaluation of both probable risk-adjusted returns and local economic impacts (see below). Largely as a result of this dual focus, Greystone has persevered with development spending, even during periods when such was rare elsewhere in Canadian real estate markets (e.g., the early 1990s).

Greystone was initiated by a group of jointly-trusteed private sector pension funds interested in obtaining financial returns from development, as well as non-financial returns, such as employment for unionized workers (who are also pension plan members) in the province. At present, shareholders in its corporate structure are twenty-four British Columbia and national plans for construction-related trades as well as those from other industries, such as the IWA Forest Industry Pension Plan, the Pulp and Paper Industry Pension Plan, the Teamsters' Canadian Pension Plan and the Telecommunications Workers' Pension Plan.[125]

There has been considerable interest expressed by fiduciaries at similar pension funds across Canada to replicate the Greystone experience in their province or region. Interest has been further prompted by the founding of Mortgage Fund One in 1992, also in British Columbia. Now capitalized by fourteen pension funds at a level of $100 million, this pool provides loans underwritten by mortgages to new construction and upgrading of primarily commercial sites, also using local unionized labour. There are a dozen current portfolio transactions (including several partnerships with Greystone) located in Vancouver, Vancouver Island and other provincial communities.[126]

Their American Cousins

Canadian vehicles that pool pension assets to back real estate — and particularly those with ancillary development goals — have American counterparts. Indeed, some of the latter are multi-billion dollar syndications leveraged by hundreds of pension funds and often actively supported by government. A long-standing version is the Housing Investment Trust (HIT), sponsored by the AFL-CIO.

Founded in 1964, the AFL-CIO's HIT has a mandate to support development projects that yield new or revitalized, affordable housing stock across the United States, while simultaneously ensuring financial returns that match or surpass market benchmarks. Transactions must also put union members to work. The trust today invests at an average rate of $400 million per year, achieved through mortgage-backed securities, mortgages, construction loans and other financial instruments. Most of these are insured or guaranteed by federal authorities or some public guarantor agencies, known colloquially as Fannie Mae, Ginnie Mae and Freddie Mac.

HIT's focus is new construction or rehabilitation of single and multi-family dwellings for which it offers debt financing (e.g., loans of between $1-35 million) undertaken in partnership with private lending institutions. For instance, bonds are issued to help finance developments favouring low and middle-income families while loans may be geared to building or renovating nursing homes, intermediate care facilities and retirement centres. In most instances, HIT money reaches local developers, public housing agencies, community and non-profit organizations and other parties that share its outlook. The current investment portfolio is valued at $1.9 billion. Over its lifetime, HIT has extended over $2 billion to residential investment activity and reports having facilitated 50,000 units of single and multi-family dwellings across the United States and creating 40,000 jobs in construction and related industries.

In 1987, the HIT was joined by the Building Investment Trust (BIT). With approximately $700 million in total assets in 1998, this second trust engages in direct debt and equity financing of commercial, industrial and retail developments nationwide, as well as apartment projects (currently comprising 35 percent of the portfolio, and growing), in association with several realty companies. In 1993, both trusts joined the National Partnership for Community Investment in collaboration with the federal Department of Housing and Urban Development and others to commit over $500 million to residential and non-residential development in twenty-five American cities.

In 1998, HIT and BIT capitalization was provided by over 400 and 70 institutional investors, respectively, the vast majority of which are jointly-trusteed multi-employer and public sector pension plans. These also share in labour-management administration of the trusts. Several other American real estate pools exist with similar mandates and extensive pension participation, including the $1 billion "J for Jobs" program of the Union Labor Life Insurance Company (ULLICO) and the $1.6 billion Multi-Employer Property Trust. ULLICO recently entered a long-term, $600 million co-investment initiative with CalPERS and the New York State Common Retirement Fund for new commercial construction in two states.

Sources: AFL-CIO HIT and BIT, *Brochures*, 1998 and *Annual Reports*, 1997; MEPT, *Brochures*, 1997; ULLICO, *Brochures*, 1997; CLMPC interviews, 1998

The local dimension

As a salient characteristic of supply and demand trends in markets for real estate is a local setting, the economic ramifications of investment tend to devolve to specific communities and regions of the country. Where there is expenditure on development and redevelopment, long-term transactions frequently involve local contractors and construction firms, tradespeople, service providers and input suppliers, and the community is the recipient of new or improved housing stock or business infrastructure.

The property-holding of pension funds, and development activity supported directly or indirectly by their assets, are also local in context. Furthermore, diversification by geography, as indicated in several of the case profiles above (e.g., Morguard Investments) contributes to fairly wide distribution of potential effects.

With respect to total assets allocated, the chief beneficiaries are probably major Canadian urban centres where most existing commercial, industrial and retail properties and high-yield development opportunities reside, though a few funds and their market agents sometimes cast the net wider. For the most part, collateral benefits realized in a local or regional economy are incidental and undocumented — though no less valid. Only in pension-backed mechanisms for real estate investing, where a collateral impact is calculated are outcomes of individual projects are recorded.

This is amply illustrated by Greystone Properties and Mortgage Fund One and their mandates to strategically target gaps in residential and non-residential stock and employ residents in urban and rural communities of British Columbia, among other objectives. The former's tally of hours of local work generated since inception, for instance, is over 4 million. Greystone's latest venture — designing and building new recreational, trade and portside transportation facilities at Vancouver's Canada Place — is expected to create over 11,000 jobs.[127]

There is also evidence of a substantial impact on housing in Vancouver. In the early 1990s, the Canada Mortgage and Housing Corporation credited Greystone for a pivotal role in addressing chronic supply shortages of new and affordable rental accomodation in the city.[128]

Comparable syndications in the United States (see **Their American Cousins**) also suggest distinctive local results. A 1997 study conducted by the University of California examined the micro-level impact of financing development by two small jointly-trusteed pension plans in the state. Both plans tapped into established pools, including the Housing and Business Investment Trusts of the AFL-CIO. Along with solid returns, measured against conventional market indices, the efforts of these plans were found to produce new jobs, favouring local union members. Moreover, investment activity led to meaningful improvements to the quality and quantity of local housing stock, especially for low and middle-income residents in the northern California community of Los Lirios.[129]

Several Canadian public sector pension funds are also attentive to targeting economic and social benefits close-to-home, where financially feasible. This is readily apparent in the operations of the Caisse Real Estate Group. Even where the Caisse invests globally, there is promotion of Quebec enterprises exporting realty goods and services or having them used in overseas co-investments.[130]

British Columbia public sector funds are similarly motivated. In 1997, the OCIO reported that 47 percent of its property holdings were province-based. In addition, over 60 percent of its mortgage program is invested in local real estate development, close to half of which supported construction of apartments, condominiums and townhouses. A key advisor to OCIO is Penreal Capital Management (Vancouver, British Columbia), itself capitalized by up to sixty-five pension funds.[131]

Some concluding thoughts

The economic significance of real estate investing is indisputable, especially if there is a developmental component. This is true at the national, provincial and local levels. It may be fairly argued, however, that such investing leaves its most palpable imprint in communities due to the immediate stimulus of project-driven jobs and the permanent (or quasi-permanent) provision of residential housing, commercial or industrial property, attendant communication and transportation facilities and other forms of public and private infrastructure. Informetrica and other research sources have confirmed what may be strong multiplier effects realized each time there is a new and sizeable development initiative.

Canadian and international real estate markets are undergoing quite revolutionary and long-term structural changes affecting both the natures of demand and supply. These must be considered in all future investment decisions and plans regarding this asset class. This said, there appears to be a pressing need to deal with the short-run problem of certain neglected development and redevelopment financing in Canada, in both the residential and non-residential spheres, and particularly where government fiscal restraints have created a vacuum (e.g., in affordable housing).

Canadian pension funds have played, and continue to play, a vital role in supplying real estate's capital resources. In general, this role has emphasized long-term property-holding and some related maintenance and development spending that favours non-residential sites in local sub-markets with evidently strong economic prospects. Many pension funds have signaled reticence in expanding investment activity beyond these parameters. This is primarily due to institutional memory of price shocks in the late 1980s or because of the powerful financial draw of public securities trading in the 1990s (though some benefit has accrued to real estate in this instance) or both.[132] A return to price appreciation in real estate may alter this situation, though as with middle market and venture investing trends, recently enhanced pension participation is chiefly the work of a few large public sector funds.

How likely is a major increase of pension asset exposure to real estate in the immediate future? As Hamilton and Heinkel have demonstrated, this depends on the ability of pension funds, and their advisors and intermediaries, to find ways of overcoming such private capital market barriers as investment illiquidity, immobility in a local context, comparatively high costs and risks and a shortage of specialty managers. Of course, these impediments may be all the greater if voluminous capital spending on land or property development figures into the equation. Costs and risks will also vary according to the types of development deals envisioned.

Though small, Canadian real estate markets are nonetheless mature and sophisticated enough to avail pension suppliers of a relatively broad array of participatory vehicles. Indeed, structural diversity that to some degree responds to the above-noted barriers appears to be on the rise with the introduction of such new external models as publicly-listed REITs. American real estate markets suggest still more alternative means and structures that may be instructive. CLMPC interviews with pension managers, market analysts and practitioners suggest that there has also been some marketplace absorption of lessons learned from the boom-bust experience of the 1980s. A frequently-cited example is more diversified geographic deployment of property-holding and development investing in the 1990s in national — and, in some cases, global — markets that contrasts somewhat with past practice.[133]

Finally, several Canadian pension funds, especially private, multi-employer funds and those in the public sector, are demonstrating a marked interest in asset allocations to certain niche investing in real estate, including that which fills some development/redevelopment financing gaps left currently by government. Examples include new construction of owner-occupied and rental housing stock, some of which is geared-to-income or not-for-profit, and selected commercial/industrial development. A parallel interest among Canadian pension funds has arisen in relation to infrastructure and public works investment (see **Infrastructure: The Newest Asset Class?**). Some of this new attention to both real estate and infrastructure assets includes explicit objectives for supplementary job creation (e.g., use of local building contractors employing pension plan and/or union members).

Precedents set in both Canada and the United States suggest that considerable potential lies in such asset-targeting by pension funds, individually or through collective strategies, that occasionally includes partnerships with government. Indeed, an approach that emphasizes leveraging of new private supply sources may suit the latter in municipal, provincial and federal jurisdictions in light of the strain on public finances at present.

Because of real estate's roots in private capital markets, it is relevant to the next section of this report, **Pension Barriers to Financing New Economy Investment**. This section is equally relevant to questions related to infrastructure investing.

8. Pension Barriers to Financing New Economic Investment

Introduction

If one revisits Figure 6, it is possible to plot, at least very generally, the parameters of Canadian pension investment in most private and public capital markets of consequence to financing key economic changes taking place in the country today. Plentiful data indicate limited pension participation in venture investing, most of which is undertaken by a few very large public sector funds or their money management institutions. Less plentiful data nonetheless points to a more considerable presence in the middle market, though this is also mainly the work of large public sector funds. Pension participation in small-cap public equity is more extensive still and involves private and public sector funds of all sizes, though data cannot give this exact confirmation as yet.

As discussed in preceding sections, pension participation in these capital markets suggests a contribution to new company formations, SME growth and later-stage business development that is job-creating or job-protecting. A more traditional role for pension funds in real estate markets can also be relevant to productive, job-creating investment in the economy. Here, participation is quite extensive, on-going and broadly-based among variously-sized private sector and public sector funds, but has been slipping from levels reached in years past.

Why do pension funds shy away?

A common theme for all of these capital markets, also previously discussed, is real or potential increases, by total dollars or as a percentage of total assets, in recent pension participation in them. All available evidence indicates, however, that there are impediments - some manageable, others seemingly intractable - that impose limits on prudent and reasonable levels of pension asset allocations or the sustainability of allocations once made. Rooted in relative inefficiencies specific to each market, these are most daunting for such private capital markets as venture investing and middle market investing.

Pension barriers to financing the new economy investment that is a critical by-product of these markets are not currently well known or fully comprehended. Over the course of its research, the CLMPC attempted to compile a list of those observed by pension managers, market analysts and practitioners.

Some of these were drawn from recent studies in Canada and the United States. In particular, the writings of Mary Macdonald have shed light on transactional hurdles that are structurally endemic to the institutional venture capital market, among other factors.[134] Professor Allan Riding (Carleton University) has written similarly about other private capital markets.[135] Other sources include surveys of American pension funds and published and unpublished analyses in both countries about barriers that are market-specific.[136] In CLMPC interviews over 1997-98, senior Canadian pension fiduciaries also provided very valuable anecdotal evidence linked to their own experiences.

In the end, the CLMPC identified fourteen barriers of special relevance to Canadian pension funds that certainly resonated with individual trustees and managers with whom they were discussed. These touch on all aspects of the pension process for allocating and managing assets, including governance, investment policies and styles, the law's prudential framework, capital market structures and incentive systems.

It is safe to say that most of these barriers have, as their immediate point of reference, markets for venture and non-venture private equity. It must also be said, however, that they apply in equal measure to other forms of private debt and quasi-equity placements, such as term lending and mezzanine financing. Because of its foundation in private capital markets, relevance can also be established for many aspects of investing in real estate and infrastructure.

The CLMPC-PIAC survey

In early 1998, CLMPC received a proposal from PIAC to convert the list of barriers to a questionnaire for an opinion survey of its membership. PIAC believed this effort would assist its own inquiry into those questions members might confront in any fiduciary decision to participate in the SME financing of private capital markets. Upon agreement of this proposal, the CLMPC and PIAC proceeded to jointly draft the questionnaire. It was further agreed that survey data, once obtained, compiled and analyzed by the CLMPC, should be presented to a PIAC conference and workshop (April 29 to May 1, 1998, Victoria, British Columbia) as delegate feedback might add to a final set of insights.[137]

At the time of the survey, PIAC represented 127 pension organizations that collectively manage close to 350 pension funds and approximately $400 billion in assets.

The design of the CLMPC-PIAC survey was a simple one. In general, PIAC members were asked to weigh the importance of the previously identified fourteen barriers.

More precisely, these were thirteen-plus-one barriers, since the last deals with small and medium-sized pension funds only. It was asked of all PIAC members as some large funds were once small and the experience may have yielded some lessons worth sharing. What the survey sought to discover in this regard was the relative importance of a pension fund's "critical mass" and its related capability to diversify assets towards alternative/non-traditional investment activity. $1 billion in total assets is often described as the threshold, in the sense that most pension funds below this level may not have sufficient resources. Unless otherwise stated, small and medium-sized funds are here defined as having total assets close to $1 billion or below. Large funds tend to refer to those possessing the greatest capability for diversification based on total assets of $5 billion and above.[138]

Along with their current asset size, respondents were requested to indicate their style of asset management — external, internal or a mix of the two — as these data might provide still more intelligence. Finally, respondents were invited to comment on their ratings and suggest ways by which to overcome barriers, if possible.

PIAC sent out the survey in March, 1998. By April 1st, 53 percent of PIAC members had answered, reflecting a fairly wide representation of funds according to size. These data are found in Figure 14.

CLMPC-PIAC survey results

The findings of the CLMPC-PIAC survey are valuable as they help to illuminate the potential limits and opportunities of a role for pension funds in a new and changing Canadian economy. Many PIAC respondent ratings were grounded in experience in such markets as private equity (both venture and non-venture), mezzanine financing, term lending and real estate, while others probably reflect initial consideration of what are still unfamiliar alternative/non traditional asset classes.

Perhaps the first finding of significance (see Figure 14) is that nine of the fourteen barriers received an overall rating of important or very important. Six, all pertaining to impediments implied in the complex and prohibitive structures of private capital markets, were so rated by very wide margins - from two-thirds to three-quarters of total respondents. The apparent general suggestion is that, experienced in them or not, pension fiduciaries believe such markets present clear and direct challenges to entry or sustained involvement by their funds.

The following is an overview of the barriers in order of PIAC member ratings and commentary. This is accompanied by some preliminary discussion of alternative means and structures intended to strategically overcome barriers. These mostly derive from CLMPC research into assorted private capital markets in North American and Australasia — and, in particular, highly-evolved private equity investing in the United States — usually as barrier-specific responses developed over time by practitioners on the demand or supply sides and frequently with the support of public policy. In many cases, organizational and technical innovations have been pension-led as the capital commitments of funds in these jurisdictions expanded and gave fiduciaries more influence in market development.

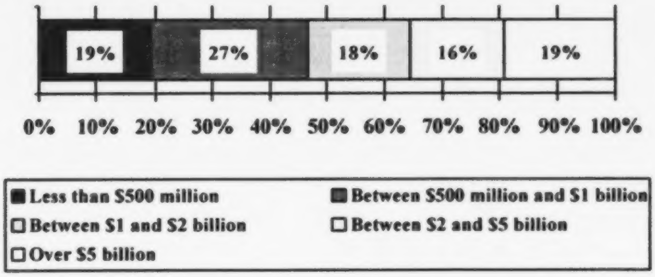
Primary examples of strategic solutions addressing the top-rated barriers identified in the CLMPC-PIAC survey may be categorized in following manner:

- ✓ Introduction of "best practices" to conventional pooling vehicles and syndicates (e.g., limited partnerships in private equity and subordinated debt markets);
- ✓ Establishment of new and alternative pooling vehicles (e.g., fund-of-funds: pools that intermediate between pension suppliers and external specialty managers);
- ✓ Establishment of alternative asset-targeting pools and strategies (e.g., American economically-targeted investments, or ETIs, for real estate, SME financing, venture capital, etc.);
- ✓ Development of seasoned, skilled investment specialists for key capital markets or market segments;
- ✓ Development of market-specific advisers and agents to facilitate transacting (e.g., gatekeeper intermediaries for pension funds and SME agents in American private equity investing);
- ✓ Creation of private capital market returns databases, performance assessment and measurement tools, et al;
- ✓ Improvement of private capital market education for pension fiduciaries;
- ✓ Establishment of government-private sector partnerships for leveraging, cost-sharing or otherwise advancing any of the above initiatives.

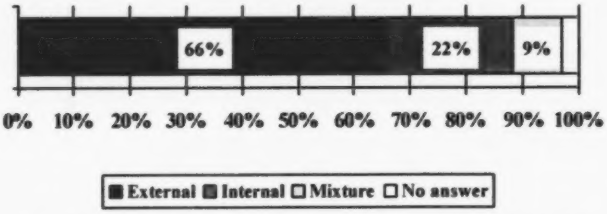
Further clarification of these and other examples is found under **Of Pools and Pooling**, **What's A Gatekeeper?** and **What's an ETI?**.

Figure 14
CLMPC-PIAC Survey
Introduction to Key Findings

- **Survey response rate was quite high: 53%**
- **Among PIAC respondents, there was broad representation by size:**



- **Most PIAC respondents had an external asset management style:**



- **Nine of the fourteen barriers identified received an overall rating of important or very important**
- **Six barriers were rated as important or very important by between two-thirds to three-quarters of total PIAC respondents**
- **Certain barriers linked to the structure of private capital markets (i.e., costs and risks, management/information intensity, supply of specialists, etc.) received most emphasis in ratings and related comments.**

Source: CLMPC, 1998.

(1) Concern that such investment activity is management-intensive and, hence, will result in unacceptably high pension operating costs.

Simply put, private capital markets are information-problematic. This fundamental trait necessitates the gathering and analysis of data on a constant basis by reputable firms with personnel knowledgeable about them. This is the only way to conduct appropriate due diligence and discover strong prospects for high-yield deals. In addition to absorbing some of the up-front costs of the external specialty manager - and/or other market agents and intermediaries - in conducting this task, the pension fund must incur supplementary oversight and review costs (or incur all of these costs in-house). While ultimate returns from investing may validate the exercise, undertaking it may be difficult for cost-sensitive pension fiduciaries, especially at the outset.

This was the top-rated barrier, as seen in Figure 15. A total of 78 percent of PIAC respondents rated it as *important* (36 percent) or *very important* (42 percent). Large pension funds gave this barrier considerable emphasis (85 percent *important/very important*).

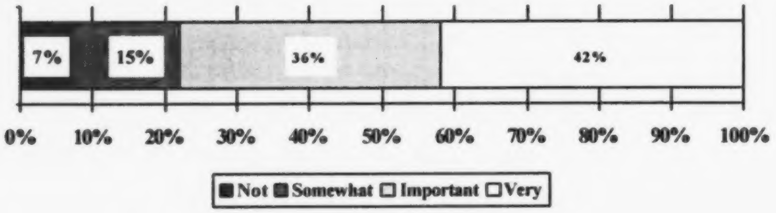
PIAC respondents made it plain that trustees expect investment returns that are not only risk-adjusted, but cost-adjusted. For those that might utilize external pooling vehicles, such as limited partnerships, costs include management fee structures and other financial/profit-sharing items. These, many fiduciaries believe, are frequently disconnected from actual budgets and operating expenses of pools. Past experience in private capital markets (e.g., merchant banking and venture financing in the 1980s) has contributed to these criticisms of financial charge practices. Of course, performance monitoring and evaluation also entail costs implied in internal staff time, attention and resources. On balance, many respondents found total direct and indirect expenditures excessive for what is, after all, a modest asset allocation.

It seems clear from the foregoing that many Canadian pension fiduciaries will not be convinced about the legitimacy of up-front and overhead costs until they have confidence in superior returns. They must also have certainty in the value-added over and above costs, including the cost of giving incentives to professionals. Some large Canadian pension funds may be more comfortable here given their capacity for controlling expenditures through in-house management of alternative/non-traditional asset programs and by limiting exposure to a few sizeable transactions. This strategy is less viable for private capital markets focussing on smaller projects and dollar amounts (e.g., much SME term lending, venture financing) for which externally-managed pools and syndications are generally the only option open to pension funds, irrespective of size.

In considering this question, Canadian fiduciaries may be well-advised to look at recent market developments in the United States. For instance, it was partially a motivation to effect cost savings that led American pension funds to recently seek much more influence over the operation of partnerships/pools and negotiate reforms. In so doing, such funds have urged a more clearly-articulated, equitable and transparent balance of interests between themselves as suppliers and external managers.[139]

Given the clout the former exercise today in American venture and non-venture equity and subordinated debt markets, this effort has translated into substantial reform of the limited partnership model of relevance to these same Canadian markets. Among emerging "best practices" are new approaches to the disclosure of actual partnership expenses and alternatives to calculating fees that are more acceptable to pension funds. Cost sensitivities are also addressed in changes to management compensatory provisions, including performance-based incentives. One feature that is increasingly found in partnership agreements is the "hurdle rate" or a minimum rate of return achieved prior

Figure 15
CLMPC-PIAC Survey
Barrier #1:
Investing Is Management-Intensive, Costly



Highlights

- **Over three-quarters (78%) of PIAC respondents rated this barrier as important or very important**
- **Little variance by size of pension fund**

Some PIAC Member Comments

- **Returns from investment must be cost-adjusted**
- **Costs = fee structures of external investment specialists**
- **Costs = internal pension allocation of staff time and resources (e.g., monitoring)**
- **Costs excessive for so small an asset allocation**

Source: CLMPC, 1998.

to sharing profits with managers.

Pension funds in the United States have also been involved in developing alternative syndicate arrangements, such as the fund-of-funds that attempts, among other objectives, to lower the cost of pension participation in these markets. These and other examples are discussed further in **Of Pools and Pooling**.

Finally, a 1995 study by the Federal Reserve System has attested to the rapid growth of advisors and agents in American private equity investing with mandates to acquire data on behalf of clients on both the supply side (i.e., institutional investors) and the demand side (i.e., SMEs) and to network and achieve matches between them. Such professionals, certain categories of whom can also be found in Australian markets, have realized some cost-effectiveness in transacting. Among the most important of these to pension funds are gatekeepers (see **What's a Gatekeeper?**). These advisor-agents often assume virtually all of the management-intensive costs of pension clients through either a fund-of-funds (in the case of small and medium-sized funds) or a separate account (in the case of large funds).[140]

Many of these innovations are also observable in, or applicable to, American ETI programs.

(2) Too few knowledgeable, qualified and/or experienced investment specialists to effectively manage pension assets internally or as part of an external pooling arrangement.

Years ago, Mary Macdonald warned of the potential limits to full maturation of the Canadian venture capital market in light of too small a stock of management professionals with the knowledge, skills and backgrounds necessary to foster development.[141] This perspective is just as applicable to other private capital markets or market segments — some that remain undeveloped or under-developed — given distinct specializations for distinct financial functions. Considering how integral the quality of managers is to interpreting market signals, to adding value and to producing risk-adjusted returns, pension fiduciaries remain concerned about how much access they have to the larger, but still finite, number with solid track records.

As Figure 16 shows, a total of 73 percent of PIAC respondents rated this barrier as *important* (36 percent) or *very important* (37 percent). Large pension funds gave it overwhelming emphasis (92 percent *important/very important*).

Of Pools and Pooling

The organizational tool of pooling in American private equity markets has seen continuous refinement over time, much of it at the instigation of influential pension funds. As a consequence, the latter have established increasing confidence in pooling vehicles that delegate costly and management-intensive duties to external specialty managers. Prominent among these vehicles is the limited partnership, a mechanism (like that in Canada) wherein the general partner — or the external specialists — administer the pooled assets of the limited partners — or the pension funds and other investors. In the United States, close to 80 percent of venture and non-venture equity and mezzanine capital flows through limited partnerships.

As this partnership model took hold, it also began to see qualitative adaptations. Some of these were advocated by pension fiduciaries concerned about imperfectly aligned interests between general and limited partners as embodied in contracts and investment management practices. Recently, nine public sector plans, including CalPERS, CalSTERS and the New York State Common Retirement Fund, hired William M. Mercer to research this issue. Mercer found that many limited partnerships were moving in the direction of better alignment, but that specialty managers had more to do on such financial items as fees, profit-sharing and general partner equity stakes. Also reported was a need for more pension control through advisory boards, improved terms for pool liquidation/wind-down, and methods for terminating partnerships or partners due to unsatisfactory performance. The Mercer report is considered to be a statement of "best practices" by its pension sponsors for market-wide recommendation.

CalPERS has incorporated several of these best practices into its Alternative Investment Management (AIM) program. In receipt of hundreds of proposals annually from new and existing partners, a five-step screening procedure was recently implemented for AIM that includes standards for aligning general-limited partner interests. For CalPERS, alignment priorities include significant general partner equity and fees that are consistent with expenses. Other elements are pool sizes, performance-to-date, management quality and reflection of AIM's strategic priorities, such as exposure to multiple market niches and industries, long-term relationships, substantial stakes and some California-based investing. If a prospective limited partnerships passes this screen (few do), CalPERS initiates its due diligence process.

American pension funds are also diversifying their participatory means. Along with more direct investing and co-investing, this includes new vehicles, such as the "fund-of-funds", that pools assets for subsequent, strategic commitment to limited partnerships. This model offers pension funds lower costs, investment diversification for those of smaller size, and a relatively safe entry point for those new to markets. They also aim to give pension participants access to the best specialists. For these reasons, fund-of-funds have enjoyed an upswing in recent years, raising close to $4 billion in 1997. The gatekeeping firm Abbott Capital Management sponsors two fund-of-funds which disperse pension and other assets to between 15-25 limited partnerships.

Sources: CalPERS, *AIM Program*, 1997; Mercer, William M., *Key Terms and Conditions for Private Equity Investing*, 1996; *The Private Equity Analyst*, Vol. VII, Issue 11, November, 1997; CLMPC interviews

PIAC respondents argued that most Canadian private capital markets (e.g., venture and non-venture equity) are probably too slight and too immature to generate enough human resources with the skill sets to expedite pension participation of any real magnitude. Once again, the 1980s experience in the middle and venture capital markets informed outlooks as respondents cited poor relations with management professionals responsible for external syndiates. This experience also appears to have created an impression among several PIAC respondents that hard-to-locate professionals of top quality are also too expensive to hire, internally or externally. At the same time, those of lesser quality are difficult to identify in advance of asset allocations. Regardless, an exhaustive, concentrated search for specialists, said several respondents, is consuming of pension time and resources.

One of the duties of gatekeeping intermediaries in Australia and the United States is to assist pension fiduciaries in the process of finding and screening investment specialists and their parntership arrangements based on prescribed criteria. They also assume many of the management-intensive tasks of oversight. This may be a welcome organizational innovation to national private equity markets — even small ones, like those in Canada — where pension participation is constrained only because of limited access to intelligence about existing external options and their intrinsic staff qualities and specializations. Another positive consequence may be more efficient sharing of current Canadian marketplace expertise. For further details, see **What's a Gatekeeper?**.

Macdonald has also recommended cross-border, co-operative initiatives (north-south alliances) whereby Canadian pension funds can gain access to the knowledge and experience of managers and other agents in markets for private equity and mezzanine financing in the United States. This process may also result in some Canadian emulation or adaptation of market-driven American models and "best practices", as well as ETIs (See **What's an ETI?**).[142]

(3) *Lack of adequate information about private capital markets with which pension managers can make investment decisions and monitor performance over time.*

As observed many times in this document, an essential distinction between public and private capital markets is the extent to which extensive data exists for pricing in the first and not in the second. Canadian legal disclosure requirements for publicly-traded securities, designed for investor protection, are a big part of what makes this market more efficient, comparatively speaking. Pension fiduciaries can only obtain accurate, regular and up-to-date information about private markets from private sources that collect it directly (i.e., from private, closely-held SMEs) and provide it for transactional or analytical purposes. Market-specific agents who perform this task must incur substantial up-front costs.

As Figure 17 shows, a total of 69 percent of PIAC respondents rated this barrier as *important* (39 percent) or *very important* (30 percent). Small and medium-sized pension funds gave it even greater emphasis (74 percent *important/very important*).

PIAC members clearly stated their concerns about the barrier presented in the absence of private capital market information and the ways by which they are obstructed trying to acquire it. An example cited frequently (by survey respondents and in CLMPC interviews) is long-term, risk-adjusted returns data. This is a crucial point since the entire pension administrative process of examining capital markets prior to allocating assets, directly or to externally-managed pooling vehicles, is dependant on current, quality financial data. This is equally vital to the subsequent process of monitoring and reporting to trustees about investment performance trends. Without a reliable and cost-efficient mechanism for sourcing data, first-time participation may be considered unlikely for many funds. Some PIAC members believe that the relevant data is available — for a price, of course - but is sometimes of doubtful quality.

Information-problematic capital markets require pension expenditure on data-gathering specialists (external or internal) that compensate for this aspect of inefficiency. Much of this information is linked to the competitiveness of private, closely-held SMEs and, hence, is confidential and proprietory in nature and collected predominantly for meeting deal-related ends. For pension funds, the issue is one of how, and at what cost, to obtain it from either specialty managers operating on their behalf or from an independent marketplace service intended to bring demand and supply sides together in an investment transaction.

On this topic, Canadian pension fiduciaries may once again be well-advised to look at recent developments in American and Australian markets for private debt and equity placements where emerging advisory and agency infrastructure is enhancing efficiency. As discussed in some detail above (and in **Of Pools and Pooling** and **What's A Gatekeeper?**), an essential function of increasing numbers of reputable professional intermediaries for pension funds, SMEs and specialists managing external pools in these two countries is reliable fact-finding at reduced cost. Even where such intermediaries do not work directly for fiduciaries, their operation can bring greater market-specific intelligence to pension asset allocation decisions. As discussed under Barrier #12, some advisor-agents exist in Canadian merchant banking and venture financing to undertake information-intensive matchmaking of supply and demand.. Another vital source of data are market research firms, such as Macdonald & Associates in the field of Canadian private equity.

Government may also be of service here. In the early 1990s, the federal Administration in the United States established the E2 DataBank as a tool for pension funds and other institutional investors to discover more about the mechanics of high-risk, illiquid investing and its strategic management. Described as an "intersection" between private investment activity and public policy, E2 DataBank has offered clearinghouse data on certain, well-established, pension-supplied asset-targeting models (i.e., ETIs) and analyst or practitioner contacts in the marketplace. Data refer to a "two-test" formula whereby a potential investor may consider the twin goals of risk-adjusted, market-grade returns and benefits to the economy or society.[143]

(4) A perception that risk-adjusted returns from such investment activity are inadequate or unreliable.

From a financial standpoint, high-risk private investment activity is justified only if it delivers capital appreciation and returns that are well above-average and assists in diversifying pension portfolios. Most of the time, asset classes such as private equity and subordinated debt, once adjusted for risk, certainly promise higher financial rewards than traditional liquid securities (e.g., stocks and bonds). Pension fiduciaries are aware, however, that volatility can occur and that certain key determinants, such as quality business opportunities and seasoned, skilled investment management, must be present to obtain these rewards over the long haul. Questions about such matters may undermine the confidence of trustees and pension managers in projected performance.

As Figure 18 reveals, a total of 66 percent of PIAC respondents rated this barrier as *important* (36 percent) or *very important* (30 percent). Large pension funds gave this barrier even greater emphasis (69 percent *important/very important*).

PIAC respondents pointed out that there is no broad financial returns "history" for some private capital markets in Canada of interest to pension funds and other institutional investors (as exists in the United States). Of course, this circumstance may preclude informed decisions to enter markets or establishment of benchmarks to measure performance once in. Even if returns are demonstrably superior, some pension fiduciaries remain uncomfortable with possible volatility. Furthermore, returns from liquid, publicly-traded securities have been good enough in recent years to postpone entry into private capital markets. It was also apparent that experience with unsatisfactory returns - merchant banking and venture financing in the 1980s, for example - influenced some answers. A few current pension participants in these markets did not share this view, arguing instead that perceptions of inadequate or unreliable risk-adjusted returns are simply incorrect.

There were very few PIAC member recommendations for overcoming this barrier apart from the already-cited need for better flows of quality, private capital market data to pension fiduciaries. This should include, in the view of some, comparative American information on risk-adjusted returns from privately-placed debt and equity over several decades. In CLMPC interviews with pension managers, interest was also expressed about future development of an accessible, comprehensive database for Canadian venture and non-venture equity markets. Some PIAC respondents also proposed that non-participants might learn more about made-in-Canada returns from the accumulated in-house knowledge of pension funds with an unbroken presence in such markets, such as those associated with the Caisse de dépôt. Thoughts concerning the related issue of measuring long-term investment performance are provided below under Barrier #6.

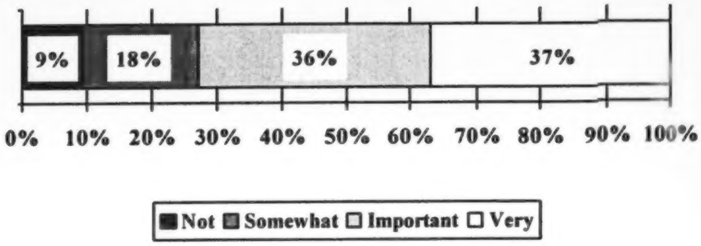
(5) Concern that such investment activity may result in high profile failures and/or severe cost liabilities.

Business failures and deal write-offs are a fact of life in private capital markets, particularly during temporary downturns in cycles. In a long-term, diversified and risk-balanced portfolio managed by seasoned investment specialists, these should not ultimately affect net financial returns. Failures can frequently gain much more profile and media attention, however, than successes. For multi-stakeholder pension funds, this is publicity that can be hazardous to the point where eventual risk-adjusted returns no longer count. Equally alarming may be costly, high profile legal conflicts over the sorting-out of liabilities in the case of deals-gone-sour and termination of partners and pools.

As Figure 19 shows, a total of 64 percent of PIAC respondents rated this barrier as *important* (30 percent) or *very important* (34 percent). Large pension funds gave it above-average emphasis (69 percent *important/very important*).

Many PIAC respondents spoke of the deleterious effects felt inside a pension fund when the details of a failed investment are published and circulated. Many funds eschew all forms of profile and publicity, let alone much unwanted negative attention. Governing fiduciaries, noted some respondents, are especially sensitive to this happening and the result is sometimes impaired decision-making at this level. As one PIAC member put it: "Bad decisions last longer than good ones." Some also believe they have little recourse when failures occur in private capital markets since, in many instances, fiduciaries are unable to take effective action against external professionals managing pools due to the terms of legal contracts.

Figure 16
CLMPC-PIAC Survey
Barrier #2:
Too Few Qualified Investment Specialists



Highlights

- **Close to three-quarters (73%) of PIAC respondents rated this barrier as important or very important**
- **Emphasized strongly by largest pension funds (above $5 billion in assets)**

Some PIAC Member Comments

- **Canadian private capital markets cannot generate many investment specialists**
- **Locating the best professionals is difficult**
- **Many pension funds "cannot afford" such investment specialists**
- **Past experience is a factor**

Source: CLMPC, 1998.

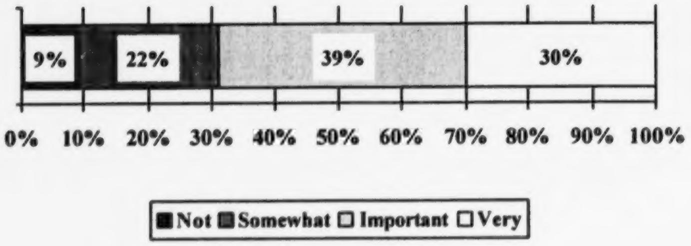
Other PIAC respondents to the survey disagreed with the above perceptions, observing that so long as overall financial returns remained sound, bad publicity is always short-term and manageable through effective communications strategies. Some saw this as an acceptable cost of pension investment activity in private capital markets.

The 1996 Mercer study, *Key Terms and Conditions of Private Equity Investing*, commissioned by American pension funds, discussed at length the complex matters of recourse over outstanding liabilities and negotiations over limited partnership terminations, terminations of specific managers, liquidations and wind-downs (for details, see **Of Pools and Pooling**). Among other things, his study emphasizes the necessity of anticipating conflict scenarios and putting protections into partnership agreements for pension suppliers. When conflict provisions are triggered, or the agreement itself is transgressed, fiduciaries should have a range of allowable actions they can take, from discontinuing capital commitments to removing members of management teams or terminating altogether. Mercer also urges a highly methodical process for concluding pools and distributing proceeds.[144] As with other "best practices" in the United States, these may prove instructive to Canadian pension fiduciaries.

(6) Conflict between traditional methods for measuring pension asset performance and the longer-term performance of such illiquid investment activity.

As stated above, governing and managing fiduciaries are hungry for information with which to assess, monitor and report on financial performance of a given asset class. Pension oversight procedures are, however, geared to conventional averages and indices for publicly-traded securities and market benchmarks that may be consulted quarterly, monthly, weekly or daily. When under-performance is clearly evident, these relatively liquid assets can be deserted or re-balanced within overall asset mixes. Illiquid investing in private capital markets cannot be judged or handled in this fashion. Deals involving private debt, equity and quasi-equity can endure up to ten years or more before exits and performance data may be unavailable or difficult to study closely in the short-term. Hence, the process of valuation is more complex.

Figure 17
CLMPC-PIAC Survey
Barrier #3:
Lack of Critical Market Information



Highlights

- **Over two-thirds (69%) of PIAC respondents rated this barrier as important or very important**
- **Emphasized strongly by smaller pension funds (below $1 billion in assets)**

Some PIAC Member Comments

- **Private market pricing of securities is difficult (as compared with public market mechanisms)**
- **Information is available, but difficult to acquire**
- **Information problems impede market evaluation**
- **Information problems impede performance measurement, monitoring**

Source: CLMPC, 1998.

As Figure 20 reveals, a total of 64 percent of PIAC respondents rated this barrier as *important* (34 percent) or *very important* (30 percent). Large pension funds gave it far greater emphasis (85 percent *important/very important*).

Several PIAC respondents confirmed that their notions of investing have been shaped by experience with well-established and proven methods for selecting and overseeing low-risk, relatively stable, liquid assets. Indeed, said some, it is liquid security performance that most determines incentive systems underlying the pension investment process (e.g., money manager compensation). Hence, there may be trouble in making the leap to securities that are, by contrast, high-risk, illiquid and occasionally unstable.

Others with stakes in private capital markets emphasized the quality of relationships between monitors (usually internal) and investment specialists (either internal or external) when determining the right variables necessary for measuring and evaluating performance. In this regard, PIAC respondents stressed the unsatisfied need for ready access to top specialists and verifiable performance-related data. Another problem identified was the incongruity of review/reporting procedures that occur over the long-term and experience in pension funds with high turnover in trustees and personnel.

One of the complexities of private capital markets, such as equity and quasi-equity, is that there is no universally-recognized standard for financial performance. As market analysts and practitioners point out, valuation is complicated by asset illiquidity and the fact that actual returns are completely determined only when these assets are successfully liquidated. Until that moment, the progress of an investment is not easily captured by a single measure or set of criteria.

In deciding to enter a market through a limited partnership or other conduit or in making judgements about potential long-term results, pension participants often rely on historical and forecasted rates of return over the lifetime of an investment or investment portfolio. Fiduciaries will receive these data in the advice of specialists. In the United States, such advice is supplemented by formalized performance calculations, such as vintage year returns data (i.e., historical earnings related to investing that occurs over parallel time periods) for private equity, provided by the analysis firm Venture Economics. There are also venture and non-venture equity indicies provided by Cambridge

Associates, based on reported valuations of pools since the 1980s.[145]

In selected external pooling vehicles, a formal benchmark may also be established. Once capital commitments are made and investing begins, fiduciaries may also monitor progress using a benchmark, among other possible tools. Recently, one American survey tried to discover how this is done by pension funds for asset performance in various private capital markets, including equity, subordinated debt and term lending. Of course, findings reveal different techniques applied to different financial instruments. A common theme has been adaptation of familiar public bond and stock indices to private benchmarking. PERA of Colorado, for instance, measures private equity returns against a benchmark of the ten-year Standard and Poor's 500 Index plus 500 basis points, as does CalPERS in combination with other tools.[146] CLMPC interviews with pension managers found this approach is similarly applied by several funds in Canada.[147]

Several PIAC members flagged an interest in developing more precise benchmarking and performance measurement methods for use in Canadian private capital markets, including adaptations of public indices (e.g., the TSE 300). It was also observed that lessons might be learned from conventional methods in other business and financial sectors, such as corporate profit projections and standards applied in banking and insurance (e.g., for debt instruments). Most acknowledged that this is a challenging and highly technical field requiring careful attention to different asset classes and sub-classes.

(7) Insufficient familiarity with, or support for, such investment activity among governing fiduciaries (i.e. trustees or sponsors) and/or managers of pension funds.

Even among the best-informed trustees, a lack of knowledge about the intricacies of private capital markets is entirely understandable. As pension analysts Keith Ambachtsheer and Don Ezra have observed, most governing fiduciaries are generalists and do not functionally require this expertise.[148] Moreover, private investment activity is outside the experience of many fiduciaries comfortable with public securities exchanges. Lack of familiarity can lead, however, to misconceptions — for example, about incidence of SME failures, deal write-offs or cyclical ups and downs in markets, all of which can be anticipated in a long-term portfolio of balanced risk. This may prevent discussion of the actual costs and risks of pension exposure to alternative/non-traditional assets. Consequently, trustees may be skeptical of proposals to create such exposure.

What's a Gatekeeper?

Why are pension funds the top-ranking source of supply to private equity and mezzanine financing markets in the United States? One explanation pertains to the series of organizational and technical innovations, some of them pension-led, that have helped compensate for market inefficiency. These have permitted the obtaining of superior risk-adjusted returns that justify pension participation.

One sign of evolution in American private equity markets since the 1980s is the rapidly growing body of independent advisors, agents and intermediaries available to both the demand and supply sides. The Federal Reserve System reports that these have proliferated due to a larger population of new investors, partnerships and pools that, in many instances, have not had direct dealings with one another. Advisor-agents provide this networking. Such also respond to the needs of participants to render the securing market information more cost-effective. For pension fiduciaries in the United States, one of the most significant professions added to the advice and agency field has certainly been the colloquially-termed "gatekeeper."

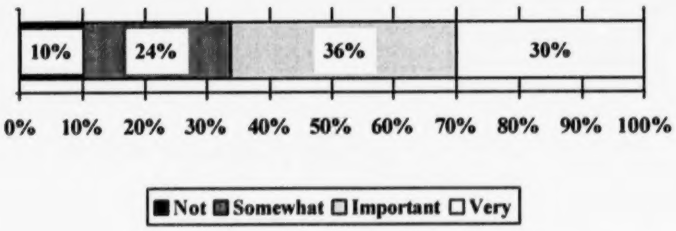
In essence, gatekeepers offer one-stop-shopping for pension funds seeking to acquire intelligence about diverse private equity investing options, to find and allocate assets to the specialists with the best track records, and to keep costs low. Some gatekeepers function primarily as consultants. Their first aim is to understand the stated criteria of pension funds and other investors. With this criteria, they then proceed to search out, screen and compare pooling vehicles (e.g., limited partnerships) and specialty managers on behalf of clients. They may also support the due diligence process. Once pension commitments are made, the gatekeeper may then undertake performance monitoring and evaluation, based on market benchmarks, and submit regular reports to fiduciaries. A well-established firm that provides clients with these and other advisory services, using a permanent database, is Cambridge Associates.

Other gatekeeping outfits are more interventionist. Some assume complete responsibility for negotiating the partnership terms and conditions and may, in such cases, retain strategic, discretionary authority over pension assets. Indeed, gatekeepers like Abbott Capital Management perform the tasks detailed above for direct dispersal to selected limited partnerships on behalf of fund-of-funds (see **Of Pools and Pooling**). The same is done for the individual portfolios of very large pension funds through separate accounts. In some accounts, large clients prefer to retain a final say in major allocation decisions through a formal approval process.

Other advisors and agents in American private equity markets have emerged to help SMEs obtain financing from pools or directly from institutional investors. This largely involves collecting private, proprietary data for profiles of the former and distributing these to the latter. Some will also handle negotiations. Still others exist to attract supply to limited partnerships. Each of these three groups, and especially gatekeepers, have assisted pension funds to avoid pitfalls, reduce operating costs and gain clarity in navigating these otherwise opaque market environments.

Sources: Cambridge Associates, *Brochures*, 1998; US Federal Reserve System, *The Economics of the Private Equity Market*, 1995; CLMPC interviewsWhat's an ETI?

Figure 18
CLMPC-PIAC Survey
Barrier #4:
Returns Are Inadequate, Unreliable



Highlights

- **Approximately two-thirds (66%) of PIAC respondents rated this barrier as important or very important**
- **Little variance by size of pension fund**

Some PIAC Member Comments

- **Returns "history" in Canadian private capital markets is limited**
- **Liquid asset returns (e.g., public equity) as good or better, currently**
- **Establishing a benchmark for returns performance is difficult**
- **Many pension fiduciaries uncomfortable with volatility**
- **Past experience is a factor**

Source: CLMPC, 1998.

As Figure 21 reveals, a total of 61 percent of PIAC respondents rated this barrier as *important* (39 percent) or *very important* (22 percent).). Small and medium-sized pension funds gave this barrier above-average emphasis (64 percent *important/very important*).

PIAC respondents tended to agree that weak support at the level of boards of trustees — and among managing fiduciaries — was frequently based on gaps in knowledge and little acquaintance with private capital markets. This is a natural outcome of boards being composed of diverse stakeholder representatives with diverse backgrounds. Interestingly, respondents felt that arguments made both for and against the idea of pension participation were often equally uninformed. Finally, trustee resistance is sometimes rooted in unfavourable past encounters (e.g., venture financing in the 1980s). One PIAC member noted the "long memory" of governing fiduciaries regarding these.

PIAC's *Effective Pension Plan Governance* (1997) asserts the need of education in a model process of trustee selection and organization, a key element of which is capital market education. Some PIAC respondents to the survey similarly recommended educational programs that include primers on certain private capital markets. Of course, these will be most useful to pension funds currently in these markets or contemplating entry. Better flows to funds of quality information elucidating the nature of markets, genuine costs and risks, likely financial returns, and alternative strategies for expediting participation, were also proposed to strengthen decision-making at the level of pension boards and committees. Canadian market researchs firms and other sources are increasingly well-equipped to supply such data on a regular basis.

(8) In the case of small and medium-sized pension funds, the fact that insufficient size may prohibit diversification into such investment activity.

Small and medium-sized pension funds (e.g., $1 billion in assets or less) encounter fairly major challenges to entering private capital markets. This has been described as the "critical mass" barrier. Due to insufficient size, smaller pension funds may be less able to take advantage of some of the rewards of wider diversification of portfolio assets or handle the substantial costs and risks associated with private debt, equity and quasi-equity. Certainly, the only way this can be done is through external pooling vehicles wherein costs and risks can be spread among multiple suppliers and specialty managers retained. A related obstacle for smaller pension funds may be lack of awareness of the selection of external partnerships and syndications available to them.

As Figure 22 illustrates, a total of 59 percent of PIAC respondents rated this barrier as *important* (31 percent) or *very important* (28 percent). Small and medium-sized pension funds gave it considerably more emphasis (68 percent *important/very important*).

In general, PIAC respondents fully appreciated the barrier implicit in small size. Not surprisingly, comments of respondents from small and medium-sized pension funds stressed its importance. In particular, the transactional and management costs discussed earlier as the highest-rated barrier are very frequently prohibitive for such funds. Given that outsourcing of asset allocations is the only option for them, this includes specialist fee structures and related partnership costs. Even more restrictive may be the smaller fund's inability to allocate staff time and resources for the purpose of oversight. Respondents also argued that the potential downsides of investing in high-risk, illiquid securities cannot be easily absorbed by funds of low critical mass. This said, some respondents believe challenges can be overcome if viable Canadian externally-managed pools exist or are initiated in future.

It should not be assumed automatically that pension participation in Canadian private capital markets is the realm of large funds, strictly speaking (though the investment dollar volumes of these certainly leave this impression). Many participants that are much smaller in size also currently subscribe to syndicate operations for investing in the middle market and the venture capital market (not to mention real estate). Incidence of their involvement may be greatest in regions where the number, depth and scope of limited partnerships and other pools is also greatest (e.g., British Columbia, Ontario, Quebec) or may otherwise be on the rise.[149]

Also of consequence here is the emergence of money management institutions (e.g., Alberta Treasury's IMD, British Columbia's OCIO and the New Brunswick IMC) emulating somewhat the function of the Caisse de dépôt in creating critical mass through multiple public pension fund deposits (as well as deposits from other sources). As the Caisse de dépôt has demonstrated, provincial sub-markets may be among the chief beneficiaries of such syndications.

See **Of Pools and Pooling** and **What's an ETI?** for details of some private capital market developments in the United States relevant to this barrier. Of special interest to Canadian small and medium-sized pension funds may be the still fairly new fund-of-funds model given its unique capacity to assist in the investment portfolio diversification of the former at a reduced cost while dealing effectively with other barriers. Many prominent, long-standing American ETIs are also based on the assets of differently-sized funds.

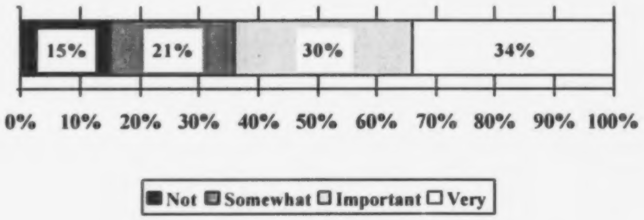
(9) Reluctance based on bad past experiences in private capital markets.

In a very real sense, this barrier lurks in the background of others. In the preceding text, allusions have already been made to the formative effect of bad experiences in the 1980s, particularly in the middle and venture capital markets (the same holds true for others, such as real estate), on the attitudes and behaviours of many Canadian pension fiduciaries. Though some pension funds, such as HOOPP, OMERS and those associated with the the Caisse de dépôt, have not been ultimately deterred by possible institutional memory of this period — for some, the experience was not bad — others have been so deterred and are resolved not to return. For this reason, this is an obstacle unto itself. Conclusions drawn by veterans may weigh less with funds that have only recently entered such markets or are considering first-time entry.[150]

A total of 55 percent of PIAC respondents rated this barrier as *important* (21 percent) or *very important* (34 percent). Large pension funds gave it still greater emphasis (61 percent *important/very important*).

PIAC respondents expressed divergent viewpoints on this topic. As expected, several respondents made note of their own bad experiences in a number of different private capital markets in the 1980s, while others expressed awareness of what their peers had encountered during that period. Some re-iterated explanations for such outcomes (for example, see **Pension Funds and Venture Investing**). For many such PIAC members, institutional memory (e.g., long-serving governing and managing fiduciaries) of a recent experience that was, on balance, decidedly negative, remains an impediment to future participation. Still others attested to a very positive and profitable experience, both historically and at the present time. For these PIAC members, staying with private equity and other markets over the long-term, and dealing openly with short-term expenditures, initial losses or volatility, has made a difference.

Figure 19
CLMPC-PIAC Survey
Barrier #5:
Potential High Profile Failures, Liabilities



Highlights

- **Close to two-thirds (64%) of PIAC respondents rated this barrier as important or very important**
- **Little variance by size of pension fund**

Some PIAC Member Comments

- **A key concern for governing fiduciaries, (e.g., trustees)**
- **Many pension funds eschew profile and publicity altogether**
- **Pension funds have little recourse when investment deals go bad**

Source: CLMPC, 1998.

As discussed in **Pension Funds and Venture Investing** and **Pension Funds and Middle Market Investing**, private capital markets to which Canadian pension funds retain some connection have undergone considerable change over the past ten-plus years. Several market analysts and practitioners have testified to stable capital supply trends, increasing expertise and specialization in pools and managers, diversity in investment activity and tools, more sophisticated entrepreneurship and many more sources of returns in burgeoning new industries (e.g., biotechnology, computer products and information technology) or in restructuring traditional ones. In the case of venture financing, evidence of new maturity has been displayed in such high technology regions as the Ottawa Valley where demand and supply matches have clearly increased in quantity and quality since the mid-1960s.[151] As noted in **From Acorns to Trees**, this is also apparent in the increased incidence of specialty or "niche" pools across Canada.

This is consistent with evolutionary trends in deeper and more established American private capital markets. In that country, pension funds have contributed quite significantly to positive outcomes and, at the same time, have made their presence as key suppliers more commodious or favourable to themselves. This has been attained by fiduciary calls for the introduction of organizational and technical innovations from market practitioners, as described under Barrier #1 in relation to venture and non-venture equity and subordinated debt investing. **Of Pools and Pooling** and **What's a Gatekeeper?** highlight some of these pension-led initiatives, intended, in many cases, to prevent the repetition of past mistakes. Australian private equity markets appears to be evolving similarly.[152]

(10) A perception that high-risk investment activity is inconsistent with fiduciary responsibilities to pension plan members.

There is a widely-held view among Canadian pension fiduciaries, their agents and advisors that fiduciary obligations to plan participants and beneficiaries, by definition, preclude involvement in most private capital markets. Generally speaking, the rationale is that pension investment must be in all respects low-risk if the promise of secure benefits for retirees is to be reliably guaranteed. Sometimes this caution is understandably linked to the constraints imposed by a pension plan's individual funding circumstances and projected stream of liabilities. In some cases, risk aversion is given formal expression in policy strictures against allocations to certain asset classes, such as high-risk, illiquid securities (e.g., private equity).

A total of 47 percent of PIAC respondents rated this barrier as *important* (28 percent) or *very important* (19 percent). Small and medium-sized pension funds gave it above-average emphasis (50 percent *important/very important*).

Several PIAC respondents confirmed that specific aspects of much private investment activity - high risk, illiquidity, return cycles, volatility - can contribute to an impression of unmanage-ability and careless treatment of pension plan assets. As compared to a strategy of sticking with core asset classes, the notion of pension participation in certain private capital markets may suggest to the uninitiated a violation of prudence and fiduciary duty. While this may not be true, said some respondents, tight restriction of overall pension exposure to such alternative/non-traditional assets is certainly justified on prudential grounds. One PIAC member argued that the real violation of fiduciary principles may be neglect of private capital markets and their growing value to diversifying portfolios and sources of earnings in a new economy.

To deal with any misconceptions surrounding this barrier, respondents again recommended supplementary educational materials and programs clarifying outlooks on fiduciary theory and practice in relation to private capital markets. Some also proposed that quality data and analysis about these markets that reaches both governing and managing fiduciaries would be of assistance here (see Barrier #7).

What's an ETI?

It's a good question. Literally, the acronym stands for "economically targeted investment", but the ETI is as much an American phenomenon as it is concept. In recent years, numerous pension funds in the United States have implemented asset allocation programs designed to meet return benchmarks and prudential standards, but also with the intention of simultaneously producing positive economic effects.

A more precise definition is elusive. The federal Department of Labor (DOL) — agent for the Employee Retirement Income Security Act (ERISA) — has described the ETI as pension investment selected, apart from its returns, for the "ancillary benefits" it may create. DOL examples include "expanded employment opportunities, increased housing availability, improved social service facilities and strengthened infrastructure." In practice, ETIs achieve this end by focussing on perceived areas of under-investment in the American economy, through a variety of financial means and structures.

While existing for decades — the earliest ETIs appear to be real estate pools, initiated in the 1960s and 1970s by multi-employer pension funds in the private sector — this model certainly gained traction in the 1990s. This is chiefly due its appeal to very large public sector pension funds, such as CalPERS, CalSTERS and funds in New York and Pennsylvania and the support afforded by city, federal and state governments, as well as large charities and endowments (e.g., the Ford Foundation). In the early 1990s, the Institute for Fiduciary Education found that 119 funds, in a majority of states, had committed almost $20 billion (US $) to various internally and externally-managed ETIs.

ETI programs reflect a dizzying array of goals. Mandated financing targets include affordable housing, commercial real estate, high technology start-ups, infrastructure investment, local economic development, minority and women entrepreneurs, mortgages of plan members, projects employing unionized workers, restructuring manufacturing firms, and SMEs. Structurally, many are straightforward adaptations of conventional market vehicles for pooling pension assets — for instance, to commit to venture investing, though perhaps geared to a specific business type or community. Others have broken new ground. New York City pension funds, such as the New York City Employees Retirement System, sponsor a unique selection of ETIs. These include a loan progam for rehabilitating multi-family and mixed-use buildings in poor neighbourhoods, mortgage-backed financing of low-income home ownership and term loans that average $100,000 for SMEs of all kinds.

ETIs also have severe critics south-of-the-border who point to some ill-fated examples at the state level where pension participation was mandatory or suggested conflict of interest situations. Many ETIs have also been widely credited, however, for creating jobs and other social goods (e.g., new housing and infrastructure stock) without apparent sacrifice of returns. A possibly decisive blow was struck for the ETI model by ERISA regulators in a series of official pronouncements in the mid-1990s, confirming its fiduciary permissibility, if appropriate risk-adjusted returns are ensured. Other legal and supervisory authorities have echoed this view.

Sources: DOL, *Interpretive Bulletins* and *Federal Regulations*, 1994; Office of the Comptroller, NYC, *Targeted Investment Programs*, 1998; Zanglein, Jayne, "Harnessing the power of pension funds", *The Labor Lawyer*, 1995

(11) *Insufficient familiarity with the needs and constraints of pension funds on the part of qualified professionals managing external pools.*

Even if there is adequate supply of investment specialists to facilitate pension involvement in private capital markets, concern exists that those situated externally may not fully comprehend or appreciate their clients. This concern embraces a wide range of managing fiduciary needs, such as constant communications, regular performance-related data for the filing of reports, transparency in partner relationships and some influence in decision-making that helps determine financial outcomes. Fiduciaries have suggested that some external professionals managing pools also seem unaware of the unique constraints of pension funds, such as prudential restrictions, accountability to trustees and plan members, and the need to maintain low operating costs.

A total of 46 percent of PIAC respondents rated this barrier as *important* (37 percent) or *very important* (9 percent). Large pension funds gave this barrier stronger emphasis (61 percent *important/very important*).

PIAC respondents tended to agree that some professionals managing external pools/syndicates in private capital markets had much to learn about the portfolio requirements of their pension clients. Several re-iterated what have frequently been unsatisfactory partnership relations of the previous decade. One past problem has had to do with the objectives and designs of many high-price products and services offered by partnership managers to pension funds as these have commonly failed to accomodate the needs or interests of the latter.

Somewhat less emphasis of this barrier by PIAC members, apparent in both ratings and comments, may be due to the fact that much Canadian pension participation in such realms as merchant banking and venture financing is, at the moment, undertaken by very large funds with internally-managed alternative/non-traditional asset programs. This said, one respondent to the survey drew attention to American pooling vehicles (e.g., limited partnerships, funds-of-funds) and market advisors and agents who, by all accounts, specialize in pension clients and their requirements as suppliers to private capital markets. Of course, this phenomenon is in line with what has been already discussed above with regard to evolving marketplace infrastructure for private equity investing, et al, in the United States and, as such, is referred to in **Of Pools and Pooling** and **What's a Gatekeeper?**.

Something of particular meaning to this barrier may be the advent of advisory committees, composed of pension and other institutional partner representatives, to American limited partnerships. The mandate of these committees is to ensure some element of supplier control over operations and, in particular, on such topics as investment valuations, conflicts of interest and potential transgressions of items in partnership agreements. Committees also give pension fiduciaries yet another venue for regular input on matters vital to their role in overseeing and reporting on performance.[153]

One Canadian venture capital institution that has implemented an advisory committee and other consultative initiatives involving pension suppliers is Ventures West Management (see **Pension Funds and Venture Investing**). In fact, Ventures West has also introduced many of the "best practices" by which to invest syndicated pension money that were described under Barrier #1 (and in **Of Pools and Pooling**), including reduced professional fees, hurdle rates and more flexibility in implementing changes to management where deemed necessary. This action points to what are some important steps being taken in market development in Canada at present.[154]

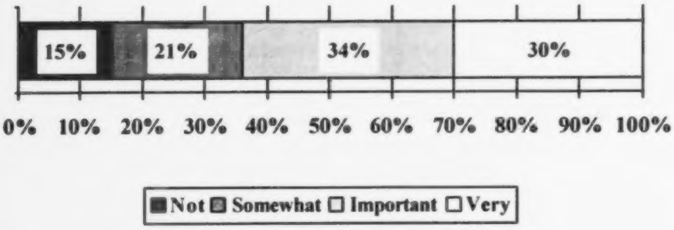
(12) *A perception that there are not enough high quality small business investment opportunities to warrant participation.*

Within the Canadian universe of new and developing SMEs seeking external financing, it is sometimes difficult for financial institutions and investors to discern which offer the best expansionary prospects and optimal earnings. The relatively small proportion of business demand that is especially growth-oriented will vary according to industry, product and economic region. Pension fiduciaries rely on industry experts, market analysts and investment specialists to make judgements. Some nevertheless believe that, in all likelihood, there is plentiful supply to private capital markets, relative to demand, currently. Indeed, in the case of the venture capital market, some have argued that there is too much money chasing too few quality deals. The result may be inflated prices and poor decisions.

A total of 43 percent of PIAC respondents rated this barrier as *important* (33 percent) or *very important* (10 percent). Large pension funds gave this barrier greater emphasis (61 percent *important/very important*).

Survey responses of PIAC members to this barrier were a little surprizing given the strong feedback from pension trustees and managers on this topic during CLMPC interviews in the months prior. In these interviews, a frequently articulated outlook was that extensive pension participation was inhibited by supply influx trends in certain private capital markets and, in particular, in venture financing (i.e., due to labour-sponsored funds and government-directed financial institutions). Also expressed was a concern that current Canadian entrepreneurship was unlikely to produce enough SMEs with credible goals for job-creating expansion in national and international markets.[155]

Figure 20
CLMPC-PIAC Survey
Barrier #6:
How To Measure Long Term Performance?



Highlights

- **Close to two-thirds (64%) of PIAC respondents rated this barrier as important or very important**
- **Emphasized strongly by largest pension funds (above $5 billion in assets)**

Some PIAC Member Comments

- **Traditionally, pension funds measure asset performance in the short-term**
- **Difficult to adapt conventional benchmarks (e.g., TSE 300)**
- **Many pension fiduciaries, agents, advisers uncomfortable with illiquidity**
- **Regular turnover of governing/managing fiduciaries is a factor**

Source: CLMPC, 1998.

In contrast, several PIAC respondents to the survey said that the relative quantity and quality of developmental business opportunities in Canada was not a serious impediment. As mentioned under Barrier #9, this may be due to evidence of a larger and more sophisticated stock of Canadian entreprenuers in such regions as the Ottawa Valley, a fact demonstrated by market practitioner Denzil Doyle (Doyletech Corporation) in a genealogy of new business formations there from 1965 to the present.[156] Rather, the problem for pension fiduciaries lies in uncertain methods for precisely and cost-effectively identifying the best opportunities for exponential growth and returns now available in traditional and non-traditional industries and sectors.

A research report by the Federal Reserve System in the United States (1995) was cited earlier for its reference to developing advisory and agency infrastructure in private equity and mezzanine financing markets there. Among the newest professionals, an important category is advisor-agents who collect information from SMEs, highlight good investment prospects to institutional investors or their pools/syndicates and attempt to put deals together (see also Barrier #3). Thus, they perform an essential function in separating wheat from chaff. Specialization of these is also on the increase as some advisor-agents concentrate on firms of a specific size or at a specific stage of development. SME intermediaries also act in service to selected American ETIs.[157]

While such support to informed and more fluid supply-and-demand networking and matchmaking may not be as pervasive in Canadian markets, it does exist here. One example is Orenda Corporate Finance, an advisor to medium-sized and larger enterprises seeking private debt and equity placements. To this end, it gathers packages and distributes critical business data to potential investors and, in some instances, also assists clients in deal-making. Orenda has also introduced a few start-ups and early stage developments to venture backing, as it did in the case of Clearnet Communications (the cellular telecommunications firm) and OMERS in 1993.[158] Sharwood and Company is another key advisor-agent that has been similarly active in facilitating middle market expansions, management buyouts, mergers and acquisitions as well as matches requiring venture capital, both angel and institutional.[159]

(13) Certain impediments to participation that may be caused inadvertently by public policies, such as tax treatment of limited partnerships.

Recently, concerns have been raised about issues of government taxation and tax policy as inadvertent obstructions to pension investment diversification. For instance, senior Canadian pension managers have pointed to the tax definition of limited partnerships that views such partnerships as foreign property unless otherwise specified. Ensuing disincentives may also exist for potential non-resident suppliers. It is argued that the combination of these and other tax strictures undermine a key mechanism for pooling and investing pension assets in assorted private capital markets. Other tax-related concerns include how best to establish practical incentives for pension participation, including debate over the federal three-for-one rule's impact in the 1980s (see **Pension Funds and Venture Investing**), and possible lifting of the federal ceiling imposed on pension disbursements abroad (20 percent of total assets).[160]

A total of 33 percent of PIAC respondents rated this barrier as *important* (24 percent) or *very important* (9 percent).

Very few PIAC respondents commented on this barrier or provided illustrations of what they felt were the negative implications of certain public policies, and especially tax policy, for the role of pension funds in private investment activity. Some argued that government was irrelevant in this area. There was also little feedback on the specific example provided in the tax treatment of limited partnerships. This does not by any means diminish the significance of this topic in a discussion of barriers, but instead probably suggests its fairly technical nature. As well, it is likely that only a few pension managers are contending directly with related questions at present.

Senior managing fiduciaries are currently calling for an overhaul of federal tax specifications governing limited partnership arrangements relevant to both the middle and venture capital markets. In fact, PIAC has recently suggested changes to the federal Department of Finance.[161]

PIAC has also urged removal of the 20 percent foreign content limit, alleging that it has cost billions of dollars in lost revenues to pension funds at a time when economic globalization prescribes the necessity of investment freedom. Keith Ambachtsheer has stated his belief that if the ceiling was lifted, Canadian institutional investment overseas would probably settle naturally at a level around 30 percent.[162] Gradual removal of the ceiling was recommended in 1998 by the Standing Senate Committee on Banking, Trade and Commerce.[163] Some other observers oppose the ceiling's elimination, arguing that domestic priorities (e.g., SME financing, community economic development) would suffer. In this camp, some have proposed eventual introduction of additional freedoms, so long as these are matched with additional requirements for productive investment at home.

(14) Concern that high-risk investment activity may violate the letter or spirit of government prudential regulations.

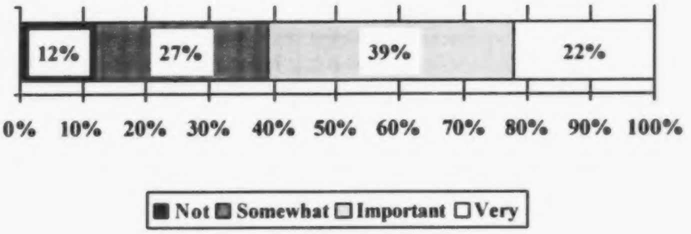
As the essential directive of Canadian legislative and regulatory frameworks, the prudent person rule emphasizes the process by which pension disbursements are made and not the specific capital markets in which they occur. As previously mentioned, this is also true in the United States and yet research there has shown that some pension fiduciaries still cite the law when electing to avoid certain high-risk private capital markets. Interestingly, this has happened even after American regulatory officials have published clarifications of legal parameters on this matter. This implies persistent gaps in knowledge. It also says a great deal about the understandable degree of caution exercised by fiduciaries because of their accountability under the law.

A total of 16 percent of PIAC respondents rated this barrier as *important* (12 percent) or *very important* (4 percent). Small and medium-sized pension funds gave it considerably more emphasis (50 percent *important/very important*).

The vast majority of PIAC respondents indicated that they did not see the law or prudential regulation and supervision by government, regardless of the jurisdiction, as a primary impediment. Some argued that if a "violation" took place, it would pertain only to injunctions contained in trustee-determined investment policies against allocations to such alternative/non-traditional asset classes.

This said, some respondents said that further and more explicit clarification of statutory requirements by Canadian regulatory authorities in federal and provincial jurisdictions is probably in order to dispel up any existing or future misconceptions in the minds of pension fiduciaries. Ideally, educational programs should also deal with these when focussing on the legal roles and responsibilities of trustees. This proposal is certainly consistent with the broad approach to pension governance recommended by PIAC's 1997 guidelines (see **Investing and Managing Pension Assets in Canada**).

Figure 21
CLMPC-PIAC Survey
Barrier #7:
Insufficient Trustee Support



Highlights

- **Well over half (61%) of PIAC respondents rated this barrier as important or very important**
- **Emphasized strongly by smaller pension funds (below $1 billion in assets)**

Some PIAC Member Comments

- **Knowledge "gaps" impair decisions of governing fiduciairies (i.e., trustees)**
- **Fiduciairies have insufficient time or resources to gain familiarity with private capital markets**
- **"For" and "against" positions are often equally uninformed**
- **Past experience is a factor**

Source: CLMPC, 1998.

Concluding thoughts

In summary, the ratings provided by PIAC respondents to the fourteen barriers contained in the CLMPC-PIAC survey underscore the significance of the structure of private capital markets as a general impediment. Privately-placed debt and equity of above-average risk implies substantial information and transaction problems that can be overcome only by long-term pension expenditure on specialty managers, internal oversight and technical adjustments of different kinds. For most PIAC respondents, the costs seem great and entail much uncertainty. This is especially true if there is no belief in superior, risk-adjusted returns at the end of the day. Most managing fiduciaries believe the decision would also prove a difficult sell to trustees.

The CLMPC-PIAC survey found little variance in ratings by size of pension fund or chosen style of asset management. Concerning the former, it was quite clear, however, that the largest pension funds placed the most emphasis on structural barriers in the marketplace, probably because of historical experience (i.e., middle and venture capital market environments in the 1980s) or because they have been grappling with such issues more recently. A second observation is that pension funds with assets of $1 billion or less clearly feel constrained by size. Fiduciaries in smaller-size funds also appear to be considerably more sensitive to pension governance and legal implications, perhaps because these have not been addressed to date.

If structural issues are at the crux of limited pension participation, then responses must invariably feature innovations in Canadian market organization, relationships and practices that help compensate for certain inefficiencies. In particular, convincing strategic arrangements must be found for directing pension assets emphasizing the use of co-investment, partnerships, pooling vehicles and other syndicates that house expertise and experience in such markets as merchant banking and venture financing. Not only must investment infrastructure yield the earnings expected of pension trustees and managers, it must fully account for their fiduciary obligations and other requirements as long-term suppliers.

It is possible that Canada may benefit from emulating certain innovations in American (and, in selected examples, Australian) markets for venture and non-venture private equity and mezzanine financing. This includes the fund-of-funds model of pension syndication and advisory and agency professional infrastructure available to institutional investors, partnerships and SMEs. Gatekeeping intermediary functions — both as advisor and agent — may provide specialized support of particular help to pension fiduciaries. Finally, many of the "best practices" advocated by pension funds and recently introduced to most limited partnerships/pools in the United States are instructive. These and other initiatives go to the heart of many of the barriers highlighted in the CLMPC-PIAC survey.

Many of these issues are technical and pertain to the "nuts and bolts" of operating in private capital markets. Most alternative models discussed here are based on mainstream principles and procedures for establishing clear signals and disciplines that will convince governing and managing fiduciaries of the reliability of cost-adjusted and risk-adjusted returns. If introduced, they offer the promise of greater maturity in even comparatively small markets like those of Canada. This, in turn, may open up new financial opportunities for suppliers. In particular, pension funds may be allowed more scope to balance assets with liabilities in the long-term and diversify.

Creative organizational strategies utilized for overcoming barriers are also crucial to realizing key Canadian economic and social goals. This is as much true for pension investment activity that is driven exclusively by the prospect of maximizing financial returns, where collateral benefits may be incidental, as it is for American ETIs and comparable Canadian asset-targeting models, where collateral benefits are planned as a subset of earnings. Ultimately, both kinds of asset allocations must find effective means for negotiating inherently inefficient private capital markets.

With regard to ETIs, et al, an additional point should be made. In the United States, ETI programs concentrate on eliciting certain collateral benefits, such as employment, housing and local development (see **What's an ETI?**), by identifying a capital market gap that has led to under-investment in the first place. Several ETIs have long and efficacious track records in capturing both financial and non-financial returns, the former measured against conventional market benchmarks. This usually has occurred because a given ETI program has married its economic and social investment goals with proven operational techniques adapted or adopted from mainstream capital markets.

Several high profile American ETIs and ETI-like programs referenced in this document - such as the HIT and BIT of the AFL-CIO (see **Pension Funds and Real Estate Investing**), the venture capital pools of PERA of Colorado (see **Pension Funds and Venture Investing**) the debt financing initiatives of SWIB and the Texas Growth Fund and ULLICO's Private Capital Fund (see **Pension Funds and Middle Market Investing**) — attest to this strategy in practice.

This is also apparent in the 1997 study conducted by the University of Wisconsin-Milwaukee Center for Economic Development (UW-MCED) that proposed new ETIs for Wisconsin (see **Pension Funds and Public Equity Investing**). UW-MCED examined numerous access to capital issues pertinent to job-creating SMEs in the state and found potential gaps in micro-lending, start-up and early stage venture financing, middle market investing in certain sectors and small-cap public equity. To deal with these, UW-MCED recommended a range of strategic responses that drew on the experience of high-performing, market-specific ETIs elswhere.[164]

Of course, there are asset-targeting models closer-to-home that tell a similar story. It has only been by methodically overcoming barriers to entry and sustained participation in private capital markets that the Caisse de dépôt has been able to fulfill its original mandate to generate market-grade, risk-adjusted returns while investing in Quebec economic growth and job creation. Indeed, as discussed in **Caisse de dépôt: Ways and Means**, Canada's largest manager of pension money can legimately claim to specialize in dealing with access to capital problems of all kinds, regardless of their nature or the requisite supply solution. The same may be said of Greystone Properties and Mortgage Fund One as they target real estate assets in British Columbia.

Public policy can play a vital role in this area. As the Organization for Economic Development and Co-operation has shown, governments in all advanced industrialized countries, including Canada, have a long history of direct and indirect intervention in the financial system to ensure adequate supply conditions for investment in new and developing SMEs.[165] At home, assorted policies and programs at the federal and provincial levels exist for this purpose. Most are geared to those markets where the need is perceived to be greatest, such as term lending and venture financing.

There is ample precedent for governments to assist pension assets gain more exposure to those capital markets that best serve Canada's productivity and jobs potential. As PIAC member responses to the fourteen barriers indicate, governments should focus on such initiatives as tailoring tax policies, facilitating the development of marketplace infrastructure and human resources, co-investing or partnering with funds on certain asset-targeting projects (i.e., where collateral benefits are intended), leveraging new asset allocations with fiscal (tax or spending) incentives and providing asset-specific insurance or underwriting (e.g., real estate, also where collateral benefits are intended). By emphasizing government-private sector partnerships that explicitly address impediments, Canadian public policy can contribute to broad pension participation that is not merely new or renewed, but sustained over time.

Conclusion

As of 1998, Canadian employer-sponsored pension funds have expanded to unprecedented size, individually and collectively, and have become a much larger institutional receptacle of national savings. This is mainly of significance to their integral social policy mandate of providing secure retirement income to working households as a supplement to public pensions. It is also significant, as never before, to the challenge facing the entire Canadian financial system to ensure that the country's savings are effectively and efficiently organized and directed to meet the productive investment and capital formation priorities of most consequence to a changing economy. A key measure of success in this regard is the long-term results for job opportunities in Canada.

Patience, Prudence and Jobs has been a preliminary, detailed investigation into many of issues and themes relevant to a pension investment role in Canada's transition and adjustment to a new economy and employment base. A critical aspect of this role is support for new and development SMEs in accessing capital, nationally, locally and by industry. As the CLMPC-PIAC survey of 1998 has confirmed, pension funds of all sizes encounter formidable barriers in this regard, primarily because of the information-intensive, management-intensive costs and risks of private capital markets that are intrinsic to all such investment activity. There are also barriers to enhanced pension participation in the low-capitalization end of public securities exchanges that also contribute to this process, and in real estate and infrastructure investing.

To overcome these barriers, organizational and technical innovations and financial specializations that are specific to individual capital markets and market segments must be developed. These must deal with the fact that such markets are comparatively small and, in some instances, not fully mature. Furthermore, to be effective, new strategic means must fully account for the fiduciary needs, constraints and marketplace outlooks unique to pension funds as multi-stakeholder, government-regulated financial institutions. If there is failure on this score, pension asset allocations will not occur or will not be sustained over time. Furthermore, as the 1980s experience in several Canadian private capital markets has abundantly demonstrated, failure once confirmed may preclude any return to them in future.

The following are some concluding observations on the Canadian capital market participation of pension funds, based on CLMPC research and interviews with pension managers, market analysts and practitioners:

- ✓ Pension investment in the venture capital market has fallen off outside of Quebec since the 1980s, though a rebound in participation may have occurred in 1997, led by large public sector funds or their money management institutions. Surmounting barriers identified in the CLMPC-PIAC survey is crucial to building on this trend nationwide and in provincial and local sub-markets. Externally-managed pools are especially vital to this result;
- ✓ Pension participation in the middle market, and in financing restructuring, traditional medium-sized firms, has been increasing since the early 1990s. Again, this has been at the initiative of large public sector funds or their money management institutions. Barriers identified by the CLMPC-PIAC survey are also key here if there is to be more pension supply, in-house or externally, to non-venture equity, mezzanine financing and term lending;
- ✓ Pension asset exposure to public equity has recently grown to reach 50 percent in aggregate. Though variously-sized private and public sector funds invest in small-cap stock issues, this appears to be restricted by structural inefficiency at the low-end of exchanges. More small-cap investment specialists and vehicles may be required to improve this situation;
- ✓ Canadian pension shareholder activism is on the rise, demonstrating features similar to activism in other countries. This includes a new interest on the part of labour and other pension stakeholders with regard to corporate governance issues. Ideally, this should be mutually beneficial to funds, stakeholders and publicly-listed firms, both large-cap and small-cap;
- ✓ Pension investment in real estate markets has declined overall since the 1990s, but has also shown some improvement in 1997. Though new asset allocations have come predominantly from large public sector funds or their money management institutions, real estate remains a focus of private and public sector funds of all sizes. Developmental real estate and infrastructure investing in future also requires the overcoming of structural impediments.

In the Introduction, it was observed that financial returns-driven pension investment is often likely to generate collateral benefits to the economy or society, either intentionally or unintentionally. To the extent that pension assets have some exposure to investment activity in some of the capital markets or market segments discussed here, there is a better chance that funds will intersect and interact with national economic and restructuring trends. Hence, there will a contribution to new business formation and development in knowledge-based and technology-intensive industries, as well as more traditional construction, manufacturing, resource and service industries.

In this case, the collateral benefits produced may be the creation or preservation of "good" jobs and incomes. Depending on the specific allocation of assets, benefits may also include community and regional economic development. In other cases, the benefits may also be new or improved stocks of residential (rental or owner-occupied) housing or commercial and industrial property. Alternatively, it may be public works and communications and transportation infrastructure. It may be any of these with additional equity features attached. The list goes on. Such collateral benefits materialize from much Canadian pension investing already. More can be reasonably anticipated with more concentration on overcoming market-specific barriers to pension participation.

Individual sections of this CLMPC report have provided anecdotal evidence of how pension funds go about maximizing returns that may also yield such collateral benefits. Options range from the direct, internally-managed alternative/non-traditional asset programs and subsidiaries of large private and public sector funds to the range of indirect, externally-managed vehicles — corporate syndicates, limited partnerships, project-by-project co-investments, etc. As discussed in relation to the CLMPC-PIAC survey, private and public capital markets in other industrialized countries (and especially the United States) reflect still more options. These may also prove instructive or worthy of emulation — including exclusively market-driven models, models that target assets and earnings (e.g., American ETIs) and government-private sector partnerships.

Canadian pension stakeholder groups have a potential role in bringing this about. The following is a brief overview of each in this regard:

- ✓ Pension fiduciaries — governing, managing and operating — and the community of financial and legal consultants that advise them — are currently involved in reforming governance processes and structures. If this is done in accordance with PIAC's 1997 guidelines, the result may be more goal-oriented, informed, sophisticated and transparent organizations. This is key to addressing some of the barriers identified in the CLMPC-PIAC survey that are linked to pension governance;

- ✓ Pension funds that have successfully achieved high-yield financial returns along with collateral benefits in alternative asset/non-traditional asset programs and schemes have a great deal to say to other funds. The positive experiences of selected cases in Canada, the United States and elsewhere internationally should be widely-shared. Other financial system members that have had to contend with economic change concerns, such as lending institutions, may also make a contribution here.

- ✓ Regulators and supervisors in the federal and provincial jurisdictions have a responsibility to ensure that the law and legal interpretation is in all respects clear concerning pension investment in high-risk, illiquid asset classes. PIAC members made this suggestion in response to the CLMPC-PIAC survey;

- ✓ Business and labour constituencies possess first-hand knowledge of change and restructuring in the Canadian economy. They may be in an excellent position to advise pension fiduciaries on such issues while helping to ensure that the singular priority of all pension investing is to prudentially deliver guaranteed retirement benefits to working people and their families. For many in labour, this requires a full and equal voice at the decision-making tables of pension funds, as indicated in the OPSEU survey;

- ✓ Government at all levels can help pension funds in expanding their capital market participation where this serves public policy goals. Possible initiatives were very briefly discussed in relation to the CLMPC-PIAC survey findings. These include tax reform, facilitating infrastructure development in certain capital markets, co-investing or partnering with pension funds on certain asset-targeting projects and leveraging new asset allocations with fiscal incentives.

The topic of investing and managing employer-sponsored fund assets in a changing and restructuring economy is still a fairly new one in Canada. As mentioned at the outset, one of the biggest challenges to the CLMPC in writing this document has aggregate investment data and analysis gaps. Members of the Canadian pension community and stakeholders in business, labour and government must certainly see *Patience, Prudence and Jobs* as a first step in truly understanding and appreciating the current and potentially future contribution of pension funds. As more public policy discussion of this topic ensues, it is of paramount importance to improve the quantity and quality of related research. Priorities may include:

- ✓ further research into the contribution of pension funds to specific venture supply and disbursement trends;

- ✓ more and better data elucidating the parameters of middle market investing and its supply from pension funds and other institutional investors;

- ✓ research into pension participation in specific private debt and equity placement activity and various types of event-driven transacting;

- ✓ more and better data indicating the investment of pension funds in small-cap public equity (e.g., the Nesbitt Burns Index);
- ✓ more study of how alternative strategies for pension shareholder activism can enhance corporate performance in an economic and jobs context;
- ✓ consideration of the effects of applying social returns criteria to the investment and management of pension assets;
- ✓ a profile of the residential and non-residential development component of pension-supplied real estate investing;
- ✓ a measure of pension investment activity in the development of infrastructure and public works;
- ✓ further and more detailed investigation into how to overcome pension barriers to entry or sustained involvement in private capital markets;
- ✓ further assessment of the relative effectiveness of asset-targeting models and partnerships in Canada and abroad;
- ✓ a look at new opportunities for more labour-management co-operation in pension investment decision-making processes.

Key Project Informants

Due to the absence of extensive Canadian research literature of relevance to issues discussed in this report, the CLMPC relied on interviews with individual pension trustees, managing fiduciaries, market analysts and practitioners and stakeholders in business, labour and government. Certain informants outside of Canada also supplied data and specialist commentary pertaining to international citations, in some cases where such was not available in documented form. It is not possible to include the names of all contributors, however, the following is a list of key Canadian and non-resident consultants to the study project, the generosity and co-operation of whom proved invaluable to successful completion of the research.

Keith Ambachtsheer
President
KPA Advisory Services

Bob Anderson
Survey Manager, Income Statistics Division
Statistics Canada

Bob Baldwin
Director, Social and Economic Policy
Canadian Labour Congress

Randy Barber
Director
Center for Economic Organizing (US)

Darcie Beggs
Senior Officer, Research Branch
Canadian Union of Public Employees

Ken Bertsch
Director, Corporate Governance
Investor Responsibility Research Center (US)

David Bissett
Chairman, Chief Executive Officer and Chief Investment Officer
Bissett & Associates Investment Management

Hal Brown
Vice-President, Private Capital Fund
Union Labor Life Insurance Company

Michael Brown
President
Ventures West Management

Drew Bucknall
President and Plan Manager
Hospitals of Ontario Pension Plan

Isla Carmichael
Senior Research-Education Officer
Ontario Public Service Employees Union

Mark Carey
Economist
Board of Governors, Federal Reserve System (US)

Cathy Carlin
Portfolio Manager
Ontario Municipal Employees Retirement System

Bill Clark
Past President
Telecommunications Workers Union

Lynn Clark
Vice-President, Economic Policy and Strategic Research
Ontario Municipal Employees Retirement System

Ian Collier
Vice-President, Merchant Banking and Private Placement
Ontario Municipal Employees Retirement System

David Collins
Executive Vice-President, Portfolio Management
Penfund Management

Jean Claude Cyr
Vice President, Development and Planning and
Co-ordinator for Quebec Economic Affairs
Caisse de dépôt et placement du Québec

Nathalie Cyrenne
Director, Administration and Finance
Caisse de dépôt et placement du Québec

Leo de Bever
Vice-President, Research and Economics
Ontario Teachers Pension Plan Board

Keith Douglas
General Manager
Pension Investment Association of Canada

Wayne Foster
Chief, Pensions and Investment Policy
Department of Finance
Government of Canada

Peter Friend
Vice-President
TD Capital Group

Ken Georgetti
President
British Columbia Federation of Labour

Heather Gavin
Administrator, Central Services
Ontario Public Service Employees Union

Murray Gold
Barrister and Solicitor
Koskie Minsky

Ira Goldfine
Office of the Comptroller
City of New York

Elaine Hamilton
Senior Investment Officer
United Church of Canada Pension Fund

Tessa Hebb
President
Hebb, Knight & Associates

Robert Heinkel
Professor of Finance
University of British Columbia

Ray Held
Managing Director
Abbott Capital Management (US)

Bill Hewitt
Vice-President, Investments
Sun Life Assurance Company of Canada

Russell Hiscock
Manager, Common Stocks
Canadian National Railways Pension Trust Fund

Audrey Howe
President
ACM Advisors

Moira Hutchinson
Independent Research Consultant

Ted Jackson
Director, Centre for the Study of
Training, Investment and Economic Restructuring,
Carleton University

Monica Jaehnig
Investment Officer, Private Placements
State of Wisconsin Investment Board

Michael Jantzi
President
Michael Jantzi Research Associates

Dwight Justice
Economic and Social Policy Department
International Confederation of Free Trade Unions

Dan Kanashiro
Director, Private Investments
Investment Management Division
Alberta Treasury

Mike Keenan
Economist
Department of Finance
Government of Canada

Gilles Lamoureux
Managing Director
Orenda Corporate Finance

Michael Lay
Vice-President, Merchant Banking Group
Ontario Teachers Pension Plan Board

Malcolm Leitch
Managing Director
Penreal

Richard Lesage
Chief Investment Officer
New Brunswick Investment Management
Corporation

Robin Louis
Executive Vice President and
Chief Operating Officer
Ventures West Management

Ted Liu
Database Manager
Macdonald & Associates

Mary Macdonald
President
Macdonald & Associates

Jeffrey MacIntosh
Professor of Law
University of Toronto

Regina Markey
Consultant
AFL-CIO Housing Investment and
Business Investment Trusts

Dick Martin
Secretary-Treasurer
Canadian Labour Congress

Paul Martin
Pension Representative
British Columbia Government Employees Union

Iola Mathews
Associate Director
Arrow Private Equity Management
Rothschild Australia

Andrée Mayrand
Director, Investments
Bombardier Pension Trust

Ross McClellan
Director, Legislation and Political Action
Ontario Federation of Labour

Kevin McKenna
Managing Director
McKenna Gale Capital

Robert Mee
Vice-President
Miralta Capital

Michel Nadeau
Vice-President, Core Portfolios and
Assistant General Manager
Caisse de dépôt et placement du Québec

Astrid Noltemy
Cambridge Associates (US)

John O'Grady
John O'Grady Consulting

Robert Olsen
Senior Managing Partner,
CCFL Mezzanine Group
Canadian Corporate Funding Limited

Doug Pearce
Chief Investment Officer,
Ministry of Finance and Corporate Relations
Government of British Columbia

Fred Pinto
Analyst, Investment Research
Frank Russell Company

David Podmore
President and Chief Executive Officer,
Greystone Properties

Richard Prytula
President
Technocap

Julian Remedios
British Columbia Mercantile Corporation

Alan Riding
Professor of Finance
Carleton University

Hugh Rorison
President
Penfund Management

Carl Sonnen
President
Informetrica

Gordon Sharwood
Chairman
Sharwood and Company

Ross Steeves
Director, Investments
IWA-Forest Industry Pension Plans

Tony Stephens
President
Morguard Investments

Bob Tattersall
President
Howson Tattersall Investment Counsel

Monica Townson
Economist and Social Policy Consultant
Monica Townson Associates

David Tseng
Special Assistant
Pension and Welfare Benefits
Administration
US Department of Labor

Émile Vallée
Policy Advisor
Fédération des travailleurs et travailleuses du
Québec

Sebastian Van Berkom
President and Director
Van Berkom and Associates

Don Walcot
Chief Investment Officer
Bell Investment Management Corporation

Colin Walker
Partner
Crosbie & Company

Robert Walker
Executive Director
Social Investment Organization

Rosemary Zigrossi
Portfolio Manager
Ontario Teachers Pension Plan Board

Sam Znaimer
Senior Vice-President
Ventures West Management

A Brief Glossary of Terms

Co-investment: In general, the process by which several financial institutions and/or investors lower a transaction's cost and risk by pooling (or syndicating) their resources.

Collateral benefits (of investing): Positive effects (e.g., in the economy) produced by an investment subordinate to financial returns.

Corporate governance: The policies and practices associated with managing a business.

Debt (also known as credit or loans): Financing offered by a lending institution, repayable with interest over an agreed-upon period of time.

Due diligence: A comprehensive process by which a financial institution or investor evaluates a potential business client prior to completion of an investment agreement.

Economically-targeted investment (ETI): An investment chosen (a.k.a., asset-targeting) for both its financial and economic return merits.

Employer-sponsored pension funds: Funds based on the deferred wages of workers intended to provide income upon retirement. Statistics Canada uses this term to describe the universe of employment-based, occupational or workplace plans, the vast majority of which are trusteed. In fact, the sponsors of many pension plans are both employers and employees.

Equity capital: Financing offered by an institution or investor in private or public markets that entails some degree of firm ownership.

Fiduciaries: Persons charged with the legal responsibility of administering pension assets, be they governing (trustees), managing or operating fiduciaries.

Fiduciary responsibility: The legal obligation that fiduciaries administer pension assets with care, diligence, prudence and skill and in the sole interest of plan members.

Gatekeepers: Professional advisor-agents operating in (American) private equity markets on behalf of pension fiduciaries.

Initial public offering: The stage at which a small company may first become publicly-listed and traded on securities exchanges.

Institutional investor: This term usually refers to such large financial entities as pension funds and insurance companies.

Investment financing: Capital (debt or equity) that enables productive investment within an enterprise.

Investment infrastructure: Very generally refers to the programs, support services and structures, etc., in place to expedite investment activity and/or add value to investment projects.

Joint trusteeship: Arrangements whereby administrative powers are equally shared between employer and employee representatives. These are often found in co-contributory, multi-employer and public sector plans.

Limited partnership: A pooling vehicle often used in private equity markets to syndicate the assets of investors (general partners) under specialty management (limited partners).

Lending institution: A generic term for a bank, *caisse populaire* or credit union, etc.

Matchmaking: Very generally, the process of linking business demand with appropriate sources of financing. More specifically, this term is used to describe formal efforts to strategically link entrepreneurs with suppliers of private debt and equity capital.

Merchant banking: Also known as investment banking, this refers to privately-placed debt and equity activity in the middle market.

Mezzanine financing: Also known as subordinated debt, this is debt-like financing that possesses equity features for the purpose of assuming more flexibility and higher risk in a transaction.

Middle market: The market for privately-placed debt and equity capital available for generally sizeable investments in established medium-sized and larger enterprises.

Pension governance: The policies and practices associated with administering a pension fund.

Pools or *pooling vehicles*: Generic terms for the funding mechanism utilized by many financial institutions or investors (frequently for reasons of sharing costs and risks) to make debt or equity investments.

Private placement: A generic term for debt and equity investments of all types in private capital markets. Term lending and venture financing can fall in this category, though these tend to be identified independently.

Seasoned offering: The stocks periodically issued by active firms with established listings on public securities exchanges.

Shareholder activism: The process by which an individual or institutional holder of stocks in a firm actively asserts ownership rights to ensure value. This usually happens by a shareholder interest in corporate governance.

Small and medium-sized business: Enterprises so-defined because they have total assets, employees or sales that are comparatively small in size (e.g., 500 employees or less). Most such firms are private (i.e., they are not listed on public securities exchanges) and closely-held.

Small-capitalization (small-cap) stocks: Public equity of small dollar worth, determined by multiplying the price by the number of shares outstanding. Such capitalization is frequently defined as being less than $1 billion.

Small dollar projects: A generic term for investment deals requiring very small amounts of financing. In the case of equity, this is sometimes defined as being below $500,000, and in the case of debt, below $50,000.

Start-up: A new business at an especially early stage of development.

Subordinated debt: See *Mezzanine financing*.

Syndicate or *Syndication*: A generic term that usually refers to a partnership of financial institutions and/or investors on a single transaction (i.e., a co-investment) or as part of a more formal pooling arrangement (e.g., a corporate syndicate, a limited partnership).

Trustees: See *Fiduciaries*.

Trusteed pension funds: By far, the largest component of the employer-sponsored fund universe whereby funds are legally-registered according to a trust agreement.

Venture capital: High risk financing supplied to new and developing enterprises, unsecured by collateral and involving a significant long-term equity position.

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[84] Investment Dealers Association of Canada, *Securities Industry and Capital Markets Developments*, 1996.

[85] Jog, Vijay, "The climate for Canadian initial public offerings", found in Halpern, Paul (editor), *Financing Growth in Canada*, Industry Canada Research Series, University of Calgary Press, 1997.

[86] BDBC, supra endnote 40, 1997.

[87] Higgins, John, *Financing Emerging Business: Canada and US Cost Comparisons of Initial Public Offerings*, Conference Board of Canada, 1994.

[88] For example, see BDBC, supra endnote 40, 1997.

[89] The issue of the industrial mix of the TSE 300, and the link with emerging industrial activity financed in private capital markets, is outlined and intelligently discussed in: Znaimer, Sam, *Canadian Venture Capital in the Late 1990s - Not Like the Old Days!*, presentation to a PIAC conference, Victoria, British Columbia, April, 1998.

[90] Van Berkom, Sebastian, supra endnote 81, 1993.

[91] The Canadian office of the multi-product mega-firm noted in the text very generously provided general profile data concerning its typical pension clients, and some thoughts about interpreting the data, but declined to be cited.

[92] Ibid, 1998.

[93] CLMPC interviews, 1997-98.

[94] Pension Investment Association of Canada (PIAC) *Small Company Investment Survey* (unpublished), 1997 and 1998.

[95] CLMPC interviews, 1997-98.

[96] Investor Responsibility Research Center, 1998. See also: Fulman, Ricki, "Pension funds led corporate governance revolution" and "Shareholders keep directors feeling the heat", report on shareholder activism, *Pensions and Investments*, February 9, 1998.

[97] OMERS, 1998.

[98] Bell Investment Management Corporation, 1998.

[99] Van Berkom and Associates, 1998. This was also reported to the CLMPC by Pembrooke Management (Montreal, Quebec), 1998.

[100] Van Berkom and Associates, *Presentation to Small Capitalization Equity Forum*, 1996, *Small Cap Growth Presentation*, 1997, *Brochures*, 1998.

[101] Bissett & Associates Investment Management, *Bissett Mutual Funds Annual Report*, 1997, *Brochures* and *Newsletters*, 1998.

[102] Howson Tattersal Investment Counsel, *Welcome to Saxon* and *Brochures*, 1998.

[103] University of Wisconsin/Milwaukee Center for Economic Development (UW-MCED), *The Feasibility of Economically Targeted Investing*, 1997.

[104] Caisse de dépôt, supra endnote 11, 1998.

[105] CLMPC interviews, 1997-98.

[106] A much-quoted example, cited under "America's Shareholder Activism", is the research performed for the California Public Employees Retirement System (CalPERS) by Wilshire Associates, 1995. Indeed, the Wilshire reference is all the more relevant as CalPERS targets small-caps. For further details, see: CalPERS, *Why Corporate Governance Today?, A Policy Statement*, 1995.

[107] Hamilton, Stanley and Robert Heinkel, *The Role of Real Estate in a Pension Portfolio*, Bureau of Asset Management, University of British Columbia, 1994.

[108] For further reference, see: (1) Foot, David, *Boom, Bust, Echo*, Macfarlane, Walter & Ross, 1996 and (2) McKellar, James, "Real estate in a sponsor's portfolio", *Benefits and Pension Monitor*, Vol. 5, No. 3, 1995.

[109] Under "Characteristics of Real Estate Assets" (supra endnote 106), Professors Hamilton and Heinkel describe five qualities. In this section, the CLMPC paraphrase the writing of Hamilton and Heinkel concerning these five, while adding some further insights provided in 1997-98 interviews with pension managers, market analysts (including Professor Heinkel) and practitioners.

[110] Morguard Investments, *Brochures*, 1997-98.

[111] Ambachtsheer, Keith, *Pension Funds and the Bottom Line*, Ambachtsheer & Associates, 1992.

[112] Katmarian, Stephan and Stephen Lowrie, "The REIT stuff", *Benefits Canada*, March, 1997.

[113] Canada Mortgage and Housing Corporation, "Macro-economic impacts of the housing sector" (unpublished), prepared by Informetrica, 1998.

[114] McMorgan & Company (California), *Building Local Economies: Economic Activity and Employment Generated by Construction Activity*, 1997.

[115] McCracken, Michael and Carl Sonnen, "Infrastructure and the Canadian economy: the macroeconomic impacts", found in: Mintz, Jack and Ross Preston, *Infrastructure and Competitiveness*, John Deutsche Institute, Queen's University and Industry Canada, 1994.

[116] For example, see: Lerner, Eric, "Real estate investment: has the ugly duckling turned into a swan?" *Benefits and Pension Monitor*, Vol. 7, No. 3, 1997.

[117] Emid, Al, "Internal bleeding", *Benefits Canada*, November, 1996.

[118] OMERS and Ontario Teachers PPB, 1998.

[119] Hamilton and Heinkel, supra endnote 106, 1994.

[120] CLMPC interviews, 1997-98.

[121] Hamilton and Heinkel, supra endnote 106, 1994.

[122] Canadian National Railways Pension Fund, 1998.

[123] Caisse de dépôt, supra endnote 11, 1998.

[124] Morguard Investments, *Morguard: The Long-term Solution*, 1998, *Penfund Realty Limited: 1997 Annual Report* and *Brochures*, 1997-98.

[125] Greystone Properties, *Greystone Properties: A Developer with a Difference*, 1998 and *Brochures* and *Newsletters*, 1996-98.

[126] Mortgage Fund One, *Brochures*, 1998.

[127] Greystone Properties, 1998.

[128] Ibid, 1998.

[129] Rudd, Elizabeth and Kirsten Snow Spalding, *Economically-Targeted Investment in the Policies and Practices of Taft-Hartley Pension Funds: Two Case Studies*, prepared for the conference "High Performance Pensions: Multi-Employer Plans and the Challenges of Falling Pension Coverage and Retirement Insecurity", University of California, Berkeley, September, 1997.

[130] Caisse de dépôt, supra endnote 11, 1998.

[131] OCIO, Government of British Columbia, supra endnote 12, 1997-98.

[132] CLMPC interviews, 1997-98.

[133] Ibid, 1997-98.

[134] For example, see: Macdonald, Mary, supra endnote 36, 1991. See also the same name under **Selected Reference Materials**.

[135] Professor Riding has written extensively on the topics of Canadian angel venture financing and loan markets for SMEs, among others. For a full reference of his works and collaborations, see Riding, Allan and Barbara Orser, supra endnote 54, 1997.

[136] For instance, the Institute for Fiduciary Education has recently surveyed American public sector pension funds with regard to barriers to participation in private capital markets through economically-targeted investments.

[137] A copy of the CLMPC-PIAC survey questionnaire, compiled survey responses and CLMPC analysis can be found in: CLMPC, *Pension Barriers to Financing Small and Medium-sized Business in Canada*, presentation to a PIAC conference, Victoria, British Columbia, April, 1998.

[138] CLMPC interviews, 1997-98.

[139] A good example of American pension-led reforms of externally-managed pools and syndicates is: Mercer, William M., *Key Terms and Conditions for Private Equity Investing*, 1996. This report was commissioned by nine large public sector funds. It is discussed under **Of Pools and Pooling**.

[140] Fenn, George, Nellie Liang and Stephen Prowse, *The Economics of the Private Equity Market*, Board of Governors, Federal Reserve System, Washington, DC, 1995.

[141] Macdonald, Mary, supra endnote 36, 1991.

[142] Macdonald, Mary, supra endnote 38, 1998.

[143] E2 DataBank, *Brochures*, Government of the United States, Washington, DC, 1996.

[144] For further reference, see: Mercer, William, M., supra endnote 138, 1996.

[145] Ibid, 1996 and "Private versus public markets: annualized index returns", *The Private Equity Analyst*, Vol. VIII, Issue 1, January, 1998.

[146] McNeill, Marianna and Richard Fullenbaum, supra endnote 52, 1995.

[147] CLMPC interviews, 1997-98.

[148] Ambachtsheer, Keith and Don Ezra, supra endnote 15, 1998.

[149] For example, in **Pension Funds and Venture Investing**, reference is made to Miralta Capital and Technocap in Quebec, both of which relied in 1998 on supply from several pension funds with less than $5 billion in total assets.

[150] CLMPC interviews, 1997-98.

[151] Doyle, Denzil *A Family Tree of Home-grown Ottawa-Carleton High Technology Companies*, 1995. Mr. Doyle has illustrated the incidence of start-ups and further growth among prominent high technology firms in the Ottawa Valley since the mid-1960s, based in part on improving supply conditions.

[152] For evidence of this observation, see: Australian Venture Capital Association Limited (AVCAL), *AVCAL 1997 Survey of Venture Capital*, prepared by Arthur Andersen, 1998. It is clear from this and other sources that some examples of organizational and technical innovations that exist in American private equity markets also just now emerging and evolving in Australia.

[153] Mercer, William, M., supra endnote 138, 1996.

[154] Ventures West Management, 1998.

[155] CLMPC interviews, 1997-98.

[156] Doyle, Denzil, supra endnote 150, 1995.

[157] Fenn, George, Nellie Liang and Stephen Prowse, supra endnote 139, 1995.

[158] Orenda Corporate Finance, *Brochures*, 1998 and CLMPC interviews, 1997-98.

[159] Sharwood, Gordon, *Notes for a Presentation to the Federal Task Force on Financial Services*, Sharwood and Company, 1997.

[160] Pearce, Doug, "Letter to Kirk Falconer, CLMPC, re: tax barriers to pension investment in private capital markets in Canada", January, 1998 and CLMPC interviews, 1997-98.

[161] Ibid, 1998.

[162] Ambachtsheer, Keith, supra endnote 31, 1995.

[163] Standing Senate Committee on Banking, Trade and Commerce, supra endnote 34, 1998.

[164] UW-MCED, supra endnote 102, 1997.

[165] OECD, *SMEs: Employment, Innovation and Growth*, Paris, 1996.